
BUSINESS MANAGEMENT

Executive Manuals 74 and 75

MANAGEMENT AND THE INCOME STATEMENT—

Being Executive Manual 74, on Accounting and Statistical Control, in a Complete Plan of Training and Service for Executive Work

By

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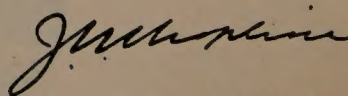
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MANAGEMENT AND THE INCOME STATEMENT

Part I

ORGANIZING THE INCOME STATEMENT

THE income statement, frequently called the profit and loss statement, is a classified summary of operational results; it is also often called an operating statement.

While the balance sheet gives a static or a still picture of the financial condition of a business at a given time, the income statement discloses the active operating factors that produced net profit or loss during a certain period of time, usually during the fiscal year of the business.

General Classification of Income Statements. An income statement is usually divided into groups of related facts which reveal the sources or causes of the net results of operational activities. These groups may be, and usually are, logically made up as follows:

Group 1

Gross Sales less returned goods and allowances equals Net Sales.

Group 2

Net Sales Minus Cost of Sales equals Gross Profit.

Group 3

Gross Profit minus Selling and Administrative Expenses (or Operating Costs) equals Net Operating Profit.

Group 4

Net Operating Profit plus Nonoperating Income minus Nonoperating Expense equals Final Net Profit or Surplus Net Profit.

As the best means of at once getting on familiar terms with fundamentals of income statements, let us consider two representative income statements, one of a manufacturing business and one of a retail store.

The Manufacturer's Income Statement. Most important as a guide to executive control is the income or profit and loss statement. Note particularly the three separate schedules that supply detail facts which support the general results appearing on the following income statement. It is precisely the operational details, as brought to light in these supporting schedules, which make an income statement valuable as a source of facts that can be used in operational control. But first read the condensed statement apart from the schedules of detail:

Y MANUFACTURING CO.			
PROFIT AND LOSS STATEMENT FOR THE YEAR			
Ending December 31, 1925			
			<i>Per Cent to Net Sales</i>
<i>Sales (Gross)</i>	\$1,000,000.00		
<i>Less—Returns and Allowances</i>	5,000.00		
<i>Net Sales</i>	\$ 995,000.00		100.00
<i>Deduct—Cost of Sales (Schedule I)</i>	575,000.00		57.79
<i>Gross Profit (Manufacturing Profit)</i>	\$ 420,000.00		42.21
<i>Deduct—Selling and Administrative Expenses</i>			
<i>Selling Expenses (Schedule II)</i>	\$150,000.00	15.08	
<i>Administrative Expenses (Schedule III)</i>	100,000.00 250,000.00	10.05 25.13	
<i>Net Profit from Operations</i>	\$ 170,000.00		17.08
<i>Add—Nonoperating Income</i>			
<i>Discounts on Purchases</i>	\$ 2,500.00		
<i>Profit from Sale of Machinery</i>	1,000.00 3,500.00		
	\$ 173,500.00		
<i>Deduct—Nonoperating Expenses</i>			
<i>Interest on Loans</i>	\$ 750.00		
<i>Discounts on Sales</i>	1,000.00 1,750.00		
<i>Total Net Profit (Carried to Surplus)</i>	\$ 171,750.00		17.26

Y MANUFACTURING CO.

SCHEDULE I

Cost of Sales—Year 1925

A. <i>Finished Stock Inventory, Jan. 1, 1925</i>	\$ 50,000.00	
B. <i>Costs of Production</i>		
<i>Inventory in Process, Jan. 1, 1925</i>	\$ 25,000.00	
<i>Add—Material Used</i>		
Raw Material Inventory		
1/1/25	\$ 15,000.00	
Purchases for Year (In-		
cluding Freight)	150,000.00	
	<u>\$165,000.00</u>	
Less—Raw Material In-		
ventory 12/31/25	16,000.00	
<i>Raw Material Used</i>	\$149,000.00	
<i>Direct Labor</i>	200,000.00	
<i>Factory Overhead</i>		
Depreciation—Buildings ..	\$ 20,000.00	
Depreciation—Machinery ..	35,000.00	
Indirect Labor	50,000.00	
Superintendence	25,000.00	
Light, Heat, and Power ..	60,000.00	
Taxes on Factory Property ..	5,000.00	
Insurance on Factory		
Property	4,000.00	
Liability Insurance	1,000.00	
Mfg. Supplies	10,000.00	
Defective Work	5,000.00	
Clerks' Salaries	10,000.00	
Factory and Machinery		
Repairs	5,000.00	
Gen. Factory Depts.		
(Planning, Production,		
Drafting, etc.)	25,000.00	\$255,000.00
	<u>\$629,000.00</u>	
<i>Deduct—Inv. in Process, 12/31/25</i>	40,000.00	589,000.00
		<u>\$639,000.00</u>
C. <i>Deduct—Finished Stock Inventory, 12/31/25</i>		64,000.00
		<u>\$675,000.00</u>
D. <i>Cost of Sales</i>		<u><u>\$575,000.00</u></u>

Operational Factors in Cost of Sales. Next, observe how the Cost of Sales (the manufacturing cost of the goods sold during the year) amounting to \$575,000 in this case, was analyzed and compiled for inclusion in the foregoing income statement. The figures in Schedule I (see page 3) were supplied by the inventory and cost records of this plant as explained in Executive Manual 38 in the section on principles of production. Note particularly the complete analysis of Factory Overhead, also the method of accounting for inventories so that the exact amounts of raw materials and of finished stock entering into the Cost of Sales for the year, are included in this cost.

The items that merit special attention in the preceding schedule covering the cost of sales are:

1. The increases in the inventories of Goods in Process and of Finished Stock.
2. The proportions existing in total factory expenditures as between Materials Used, Direct Labor, and Factory Overhead—these to be compared with previous years.
3. The ratios or the percentages of the individual items composing Factory Overhead in relation to the total of Factory Overhead—also to be compared with previous years.

Such studies at once reveal important tendencies in manufacturing operations and lead into an analysis of the causes of these tendencies.

Analysis of Selling Expenses. In Schedule II, we see the items that make up the total amount of selling expense as reported on the income statement. Schedules of this kind should always show the percentage which each item of expense bears to the total expenses. Then, by comparing these from year to year, or from month to month, the important tendencies influencing the item changes may be discovered and interpreted. The percentages to net sales are also important and may assist in budgeting these expenses in relation to future estimated sales.

Y MANUFACTURING CO.
Schedule II
SELLING EXPENSE—YEAR 1925

		<i>Per Cent to Total</i>	<i>Per Cent to Net Sales</i>
Salesmen's Salaries.....	\$ 40,000.00	26.67	4.02
Salesmen's Expenses.....	30,000.00	20.00	3.02
Sales Management Salaries.....	20,000.00	13.33	2.01
Sales Management Expenses.....	10,000.00	6.67	1.00
Advertising.....	30,000.00	20.00	3.02
Shipping Expense.....	15,000.00	10.00	1.51
Office Supplies and Postage.....	3,000.00	2.00	.30
Prorated Expense (Depreciation, Light, Heat, Repairs, Telephone, and Tele- graph).....	2,000.00	1.33	.20
	<u>\$150,000.00</u>	<u>100.00</u>	<u>15.08</u>

The foregoing percentages and items should be studied in relation to the same data for preceding years.

Analysis of Administrative Expense. The general administrative expenses as reported in this manufacturer's income statement were composed of the items shown in Schedule III, as follows:

Y MANUFACTURING CO.
Schedule III
ADMINISTRATIVE EXPENSES—YEAR 1925

		<i>Per Cent to Total</i>	<i>Per Cent to Net Profit</i>
Salaries of Executives.....	\$ 40,000.00	40	23.28
General Office Salaries.....	30,000.00	30	17.46
Expenses of Executives.....	3,000.00	3	1.75
Credits and Collections.....	10,000.00	10	5.82
Legal Expense.....	2,000.00	2	1.17
Auditing.....	2,000.00	2	1.17
Office Supplies and Postage.....	7,000.00	7	4.07
Directors' Meetings and Expenses....	1,000.00	1	.58
Prorated Expenses (Depreciation, Light, Heat, Repairs, Telephone, and Telegraph).....	5,000.00	5	2.90
	<u>\$100,000.00</u>	<u>100</u>	<u>58.20</u>

As net profits are largely the result of managerial activities, the expenses relating to management functions should be checked against the results accomplished by management; in other words, we want to know the effects of managerial activities upon profits; and we want this information comparatively from year to year. This is why the "Per Cent to Net Profit" column is shown in Schedule III.

The Retailer's Income Statement. While separate schedules were used by the manufacturer to show details of the main classes of expense, these details may be shown in the income statement itself, as illustrated in the statement of a retailer shown on the following page.

The various percentages and relationships which were recommended for study in the case of the manufacturer should receive similar attention by the retailer in so far as the latter shows similar activities.

Note that this retailer's income or profit and loss statement follows the general outline of that followed in the manufacturer's income statement—from gross sales to gross profit to net operating profit, then to total net profit after adding nonoperating income and subtracting nonoperating expense (called "miscellaneous" income and expense in the case of the retailer).

Analysis of Sales and Costs. Let us now take up the parts of an income statement one by one, beginning with sales as the chief source of income.

Manufacturers do not throw all of their manufactured products into one class for purposes of determining costs, but they find the cost of each type of product. Just as products are manufactured by different processes and at different costs, so too are they sold at different prices, in different territories, by different salesmen, at different selling costs, and under different selling conditions. Therefore—

JOHN BROWN

PROFIT AND LOSS STATEMENT

Year Ending December 31, 1925

<i>Merchandise Sales (Gross)</i>	\$102,000.00		
Less—Returns and Allowances	1,000.00		
<i>Net Merchandise Sales</i>	\$101,000.00		
<i>Deduct—Cost of Merchandise Sold</i>			
Inventory, Jan. 1, 1925	\$10,000.00		
Add—Purchases During Year	70,000.00		
		\$80,000.00	
Deduct—Inventory, Dec. 31, 1925	15,000.00	65,000.00	
<i>Gross Profit</i>	\$ 36,000.00		
<i>Deduct—Selling and General Expenses</i>			
Selling Expenses—			
Clerks' Hire	\$10,000.00		
Store Rent	2,500.00		
Delivery Expense	3,000.00		
Advertising	2,500.00		
Window Display	500.00		
Insurance	200.00		
Depreciation—Store Fixtures	1,000.00		
Taxes	300.00		
Miscellaneous	500.00	\$20,500.00	
General Expenses—			
Salary, Proprietor	\$ 3,600.00		
Telephone and Telegraph	400.00		
General Office Expenses	500.00	4,500.00	25,000.00
<i>Net Operating Profit</i>	\$ 11,000.00		
<i>Add—Miscellaneous Income</i>			
Discount on Purchases	\$ 500.00		
Sales of Waste	300.00	800.00	
		\$ 11,800.00	
<i>Deduct—Miscellaneous Expense</i>			
Credit Losses	\$ 600.00		
Loss on Sale of Fixtures	1,800.00	2,400.00	
<i>Total Profit Net (To Capital Account)</i>	\$ 9,400.00		

In order effectively to control profit or net income in business a thoro analysis of sales is necessary.

Every manufacturer and every merchant wants to know whether each type of commodity sold yields a profit. In order to secure this information, his sales must be analyzed by types of product.

The department-store manager is not satisfied to know that his store as a whole has made a profit; he wants to know the profits made on shoes, on dry goods, on furniture, on clothing, etc.; and he also may, and should, want to know the profits on different kinds of furniture, or different kinds of clothing, etc. The manufacturer making two or more different commodities is vitally interested in knowing which commodity yielded the greater profit, and why. Both merchant and manufacturer must therefore start with an analysis of sales by products, commodities, or classes of merchandise, so that the costs of these sales and the expenses of selling may be properly allocated in accordance with the analysis of sales.

Analysis of Sales by Territories. But an analysis of sales by products in the case of a manufacturer or distributor, even tho showing a profit for each product, does not go far enough. For example, Product A may show a net profit of \$50,000, but this product is sold in various sections of the country where different selling conditions exist. Sales resistance and competition may be strong in one part of the country, whereas in other sections the product may be sold with very little effort and expense. Consequently, the profit of \$50,000 on the entire product sales may be a combination of profits in some territories and of losses in others; experience indicates, very often, that such conditions exist, and their existence is often a very serious drain upon the business; upon analysis we may find, for example, that the \$50,000 profit on Product A was made in the following manner:

Profitable Sales

<i>Territory</i>	<i>Profit</i>
1	\$20,000.00
2	15,000.00
4	10,000.00
6	12,000.00
	<u>\$57,000.00</u>
<i>Less—Sales Losses</i>	<i>Loss</i>
3	\$3,000.00
5	4,000.00
	<u>7,000.00</u>
<i>Net Profit on Product A Sales.....</i>	<u><u>\$50,000.00</u></u>

In this case, the losses in sales territories 3 and 5 would not be known were the management satisfied with the profitable showing on the total sales of Product A. Knowledge of these territorial losses comes from territorial analysis of sales and costs. It is a fundamental principle of efficient executive control that—

Total profits should always be examined in order to determine the loss elements, if any, that they contain.

Analysis of Sales by Salesmen. In the above analysis of sales by territories we found that Territory 1 yielded a profit of \$20,000. This does not necessarily mean, however, that all sales in this territory were profitable. We might find, for example, that the profit (\$20,000) on Product A in Territory 1 was the result of profits realized by some salesmen from their sections of the territory and of losses sustained by other salesmen, as follows:

Profitable Sales

<i>Salesman</i>	<i>Profit</i>
Jones	\$ 6,000.00
Smith	5,000.00
Brown	8,000.00
White	7,000.00
	<u>\$26,000.00</u>
<i>Less—Sales Losses</i>	<i>Loss</i>
Johnson	\$2,000.00
Black	3,000.00
Clark	1,000.00
	<u>6,000.00</u>
<i>Net Profit on Product A Sales</i>	
<i>in Territory 1.....</i>	<u><u>\$20,000.00</u></u>

Thus, thoro analysis of sales and costs is made not only by products and by products in the various territories, but also by salesmen within the territories. And, if it is feasible to know even more, we may find that the profit of each salesman is a combination of profitable sales in certain towns or to certain customers, and of unprofitable or losing sales in other towns or to other customers. A salesman may too often visit a certain town where the possible volume of business is limited. This phase of the problem of executive control was previously covered in Executive Manual 24.

Let us bear in mind the important fact that—

Profits are generally the result of a combination of profits and losses, the profits exceeding the losses.

The need of knowing how and where profits are made and losses sustained from the sales activities is emphasized when we remember that one of the important objectives of sales analysis is the determination of sound sales policies. If, for example, a certain section of territory worked by a certain salesman indicates that profitable sales are quite impossible because of known local conditions (all disclosed by sales analysis), it becomes apparent that traveling a salesman in such a section is not desirable, and that sales there, if made at all, should be made in some other way, as thru jobbers or by mail order.

How to determine selling costs will be covered in some detail a little later on. First, we shall, in Part II, briefly analyze the cost of sales item on an income statement.

MANAGEMENT AND THE INCOME STATEMENT

Part II

ANALYZING THE COST OF SALES

THE Cost of Sales account is the cost of the goods sold. It is not to be confused with the cost or expense of selling the goods. To the retailer and wholesaler, cost of sales is the purchase price, including shipping charges to store or warehouse, of the commodities sold; to the manufacturer, it is the cost of raw materials plus the cost of manufacturing them into finished goods.

Elements in Manufacturer's Cost of Sales. The manufacturer's cost-of-sales account is the more complicated because it contains more elements. These elements are:

1. The cost of the raw materials purchased which go into the products sold.
2. The cost of the labor expended in making these products.
3. That portion of plant-and-equipment-utilization cost applicable to the products manufactured, including depreciation, repairs, light, heat, power, taxes, insurance, indirect labor, etc., all of which expenses or costs are generally designated as factory overhead or burden.

We are not here interested in the manner or method by which factory overhead is charged against the product manufactured, but we may assume, for the time being, that the method is correct and that therefore the cost of the goods manufactured is accurate.

How to Determine Gross Profit. We have seen, in Part I, how sales may be analyzed by products, territories, and salesmen. Cost of goods or products sold (cost of sales) may be similarly analyzed to determine gross profit by products, territories, and salesmen.

The cost of sales is deducted from the sales to find the gross profit. Out of the gross profit come the funds for meeting all so-called "commercial" costs or expenses, in-

cluding the costs of advertising and selling, financing, and general administration. Gross profits are determined in a retail or a wholesale business much in the same way as in a manufacturing business.

During different times of the year, where the business is seasonal, there may, of course, be some variations in the cost of sales. This is true of nearly all retail and wholesale establishments. In that type of manufacturing where there are no great seasonal fluctuations in the prices of raw material, and where labor rates remain fairly constant, the cost of sales of manufactured commodities is fairly stable thru the year, permitting a standard cost figure to be used during an entire year or period, or an average cost derived from the finished-goods inventory records, this latter cost figure being applied as the finished goods are withdrawn from stock for shipment or sale.

The Manufacturer's Cost of Sales Account. Let us analyze the manufacturer's cost-of-sales account because it brings up a wide range of control problems. First, how is cost of sales determined? The general accounting procedure is briefly as follows:

1. All purchases of raw materials and the freight charges thereon are charged to the Raw Materials Inventory account. These charges come either thru a purchase record or a voucher register; but in either event there is a credit to Accounts Payable or Vouchers Payable and a charge to Raw Materials Inventory account in the general ledger. The Raw Materials Inventory account is a controlling account (that is, a summary account) and the details of the purchases are posted into Stores Ledgers in accordance with the class or type of raw materials purchased and stored.
2. As raw materials are withdrawn from the storerooms thru properly authorized requisitions, these requisitions are credited to the individual stores accounts in the stores ledgers; in the cost department, they are charged to jobs or production orders to show the material costs. At the

end of each month, the requisitions are summarized or totaled and the amount thus arrived at is credited to Raw Materials Inventory account and charged to Inventory of Goods in Process, Manufacturing Account, or to Production Orders in Process, depending upon the kind of cost system in use. In some establishments a percentage is added to the material values to provide for the expense of storing and handling.

3. All direct labor is charged to Inventory of Goods in Process, the offsetting credit being to Vouchers Payable.
4. A further charge is made to Inventory of Goods in Process for the amount of factory overhead applicable to production.

To summarize, we have charged to Inventory of Goods in Process account, the following:

All materials going into production.

All labor expended in production.

All factory overhead applicable to production.

As products are completed, the job summaries or other methods of collecting the full costs of goods finished are tabulated and the costs of the goods finished are credited to the Inventory of Goods in Process account; the charge will be to Finished Goods account.

The Finished Goods account in the general ledger is a controlling account for the finished-goods inventory ledgers wherein will appear in detail the various manufactured commodities which are ready for sale; they appear in these ledgers at their total manufacturing cost, and from each account the unit product cost may be determined.

As the products are sold, the unit cost thereof will be multiplied by the quantities or number sold; the Cost of Sales account will be charged and Finished Goods account will be credited.

That is how the Cost of Sales account in a manufacturing plant is constructed; it has nothing to do with the cost of selling, and is limited to showing the production or manufacturing cost of the goods sold.

Cost of Sales as Related to Gross Profit. If manufacturing costs are accurate, the gross profit can then be known on every sale. Out of the gross profit all the commercial expenses of the business must be met. By knowing the gross profit and the commercial costs on every product sold, the net profit on each sale can then be closely determined.

Setting the sales price is obviously an important matter in obtaining a certain gross profit. Sales prices cannot directly influence costs, but they do directly influence gross profits. Costs are more or less fixed, especially in industries where factory operations have been standardized and the cost schedules are based upon standard costs. Under such conditions, the higher the selling price, the larger will be the gross profit.

To know the gross profit yielded by sales is a basic requirement in any further analysis of selling activities.

When we analyze sales by products, territories, and salesmen, and apply against these sales the Cost of Sales, we find the gross profits from sales by products, territories, and salesmen. The locality in which the products are sold does not affect the Cost of Sales figure, for the cost of manufacturing a certain commodity, or of purchasing merchandise for resale, is the same for all sections of the country to which the goods may be shipped. The expense of shipping the goods into the territory is not a Cost of Sales, but it is a marketing cost.

Selling Price and Gross Profit. If cost is the same for each unit of product, no matter where sold, then one important thing is the territorial selling price, because upon that will depend the gross profit from products sold in the various sales territories.

Product A may be sold in Territory 1 at an average price of \$110, and in Territory 2 at an average price of \$90. If the Cost of Sales is \$60 (it would be the same for both territories) then the unit gross profit would be

\$50 in Territory 1 and \$30 in Territory 2. Put into other language, this means that in Territory 1, \$50 per unit would be available to meet the marketing costs and to yield an expected profit; whereas, in Territory 2, only \$30 would be available for these purposes.

We cannot say, of course, that more than \$30 per unit of gross profit should have been obtained in Territory 2. It may be that \$30 is a satisfactory gross profit in territories where the volume of sales is very large and the marketing costs are relatively small. Then, too, a high sales price may include a shipping charge paid by the manufacturer which may make the large gross profit deceptive; for any shipping expense allocable to the sale must be deducted from the gross profit.

The procedure followed in determining gross profit by products, territories, and salesmen will be covered in Part III.

MANAGEMENT AND THE INCOME STATEMENT
Part III

DETERMINING GROSS PROFIT

EFFICIENT executive control is promoted by the determination of gross profit on sales by product, by territories, and by salesmen; and it is an advantage to the executive if he understands how gross profits, thus analyzed, are determined. Let us, therefore, follow a recording procedure that results in an analysis of gross profits and is of practical use in the control of business profits. This process carries us thru a series of tables.

EXPLANATION	PRODUCT A			PRODUCT B		
	Units	Total Value	Unit Value	Units	Total Value	Unit Value
Sales.....	1,000	\$100,000.00	\$100.00	1,200	\$240,000.00	\$200.00
Cost of Sales.....		60,000.00	60.00		163,000.00	140.00
Gross Profit.....	1,000	\$ 40,000.00	\$ 40.00	1,200	\$ 72,000.00	\$ 60.00

Table I. Product sales analysis.

Table I shows the sales, cost of sales, and the gross profit on each of two products, also the average sales price and the average gross profit per product unit for each product. Table II shows how the average unit sales price and gross profit on Product A were made up from results in three different territories.

EXPLANATION	SALES, ETC., OF PRODUCT A BY TERRITORIES								
	TERRITORY 1			TERRITORY 2			TERRITORY 3		
	Total Units	Total Value	Unit Values	Total Units	Total Value	Unit Values	Total Units	Total Value	Unit Values
Sales.....	200	\$22,000	\$110	300	\$27,000	\$90	500	\$51,000	\$102
Cost of Sales.....		12,000	60		18,000	60		30,000	60
Gross Profit.....	200	\$10,000	\$50	300	\$ 9,000	\$30	500	\$21,000	\$ 42

Table II. Product analysis by territories.

It is here apparent that management is following a policy of varying sales prices in different territories and is apparently selling under conditions which may make that policy necessary or perhaps desirable.

Analysis of Gross Profit by Salesmen. Table I (Product Sales Analysis) shows an average gross profit for Product A of \$40. Table II (Product Analysis by Territories) shows that there is in this case considerable variation of gross profit by territories, ranging from \$30 to \$50 per unit. Since the gross profit per unit is smallest in Territory 2 (\$30), we should probably analyze that territory first, for here we are doubtful as to whether or not a territorial profit has been earned; and if sales are unprofitable anywhere within our market, we want to know this so that we may find out why, and take steps to make the sales profitable. Therefore, we next analyze sales in Territory 2 by salesmen's districts, as shown in Table III.

EXPLANATION	SALES, ETC., PRODUCT A—TERRITORY 2—BY SALESMEN								
	SALESMAN X			SALESMAN Y			SALESMAN Z		
	Total Units	Total Value	Unit Values	Total Units	Total Value	Unit Values	Total Units	Total Value	Unit Values
Sales	105	\$8,500.00	\$80.95	95	\$9,500.00	\$100.00	100	\$9,000.00	\$90.00
Cost of Sales		6,300.00	60.00		5,700.00	60.00		6,000.00	60.00
Gross Profit	105	\$2,200.00	\$20.95	95	\$3,800.00	\$ 40.00	100	\$3,000.00	\$30.00

Table III. Sales analysis by salesmen.

The analysis in Table III shows that Salesman Y was the only salesman who sold Product A in Territory 2 at the general average unit gross profit of \$40, and that he did better than the territorial average (\$30) by \$10 per unit.

This brings us down near the real point of sales control—the gross profit per unit of sale as earned by individual salesmen.

The cause of success or failure, in the final analysis, is found in the human factor; executive control is man control aided by complete and accurate analyses of results.

Table III shows that the sales of Salesman X were made at an average unit price much below the average unit price on all sales of Product A. Yet his sales volume was only slightly larger than either Salesman Y's or Salesman Z's. Management must find out why. Is Salesman X being given too much leeway in setting prices? Is he selling small lots to customers who are potentially quantity buyers, in the hope of getting a larger share of their orders in the future? Is X's failure to show satisfactory gross profits due to a poor selling policy adopted by the management? Or is there some other explanation?

Carrying Analysis to the Real Point of Control. To determine accurately where the fault lies for X's poor showing, we should first analyze his activities in order to learn just where sales at the low prices were made, and why. We may thus disclose facts which will be of aid in formulating future sales policies and in directing the efforts of the salesmen generally.

CUSTOMERS	SALES, ETC.—SALESMAN X—TERRITORY 2—PRODUCT A							REMARKS
	SALES			COST OF SALES		GROSS PROFIT		
	Units	Value	Unit Value	Value	Unit Value	Total	Unit	
John Thomas.....	20	\$2,000.00	\$100.00	\$1,200.00	\$60.00	\$ 800.00	40.00	
Frank Smith.....	30	2,400.00	80.00	1,800.00	60.00	600.00	20.00	
Sydney Jones Co..	40	2,725.00	68.125	2,400.00	60.00	325.00	8.125	
Percy Brown.....	10	1,000.00	100.00	600.00	60.00	400.00	40.00	
James Black.....	5	375.00	75.00	300.00	60.00	75.00	15.00	
Totals and Averages.....	105	\$8,500.00	\$ 80.95	\$6,300.00	\$60.00	\$2,200.00	20.95	

Table IV. Sales analysis by customers.

An analysis of Salesman X's work is shown in Table IV. This shows conclusively that Salesman X made

some sales at the general average gross profit of \$40 per unit and that it is therefore possible to make profitable sales in his district. Investigation of the sales to the individual accounts in this case disclosed some interesting facts. For instance, the Sydney Jones Co. was a large buyer who was induced to place a small introductory order at a "quantity price"; the salesman hoping to open the way for large orders in the future. The price made to Frank Smith was the result of an effort to underbid local competition and thus to get the product established in a highly competitive district. Thus:

Analyzing the sales, cost of sales, and gross profits by products, territories, and salesmen gives, ultimately, the kind of information needed as the basis for establishing sound policies and effective control of sales efforts.

We have now carried our analysis to the point of gross profit on individual sales. But this may not be sufficient analysis for practical control purposes. Our final interest lies in net profit, and this is what remains after deducting selling and administrative expenses from gross profit. Let us first analyze selling expenses.

MANAGEMENT AND THE INCOME STATEMENT

Part IV

ANALYZING SELLING EXPENSES

WE KNOW that the gross profit must be ample to provide for the selling and the administrative expenses, also for paying interest on borrowed money—leaving a residue of net profit.

Let us remember that—

The important thing in business is the final net profit; not only the final net profit of the business as a whole, but the final net profit earned on each income-producing activity.

To obtain a final net profit from all income-producing activities is the goal of good management. Therefore, we must have statements which show not only the net profit on all sales taken together, but also the net profit from every individual sale, as far as possible, no matter where or how the sale was made.

The Need for Analyzing Marketing Costs. In order to insure the profitableness of individual sales, we must make a study or an analysis of marketing costs as these apply to the individual sales. We cannot be satisfied with a monthly profit and loss statement which shows a deduction for those selling and administrative expenses which happen to be incurred during that particular month.

The costs of marketing commodities must be related each month to the sales or shipments of that month.

Just as it costs a certain sum to manufacture the goods that are shipped (the Cost of Sales account), so it costs a certain sum to market these particular goods. We should therefore devise a plan of procedure which will establish a unit marketing cost of goods sold and shipped, as the shipments are actually made; that is, as the sales are recorded month by month for the various products,

within the various territories, and as sold by the various salesmen.

As there is a unit cost of producing a commodity, so we should find a unit cost of marketing that same commodity.

This cost of marketing should also be applied against commodity shipments or sales as they are made. Whether or not a portion of administrative expenses should be included in marketing expenses is a question which we shall consider later on. As pointed out in the Appendix of Executive Manual 24, the administrative-activity expense should eventually be prorated to the purposes served thereby.

Selling Expenses or Marketing Costs. The term Marketing Costs is probably preferable to Selling Expenses, because when we think of selling expenses we generally limit ourselves to a consideration of the more direct selling activities of the salesmen and possibly of the advertising department. If we use the term Marketing Costs, we may include therein the following items of expense:

1. Salesmen's salaries and expenses.
2. Salesmen's or agents' commissions.
3. Consignment commissions.
4. Sales management salaries and expenses.
5. Branch-office selling expenses.
6. Samples.
7. Advertising and advertising department.
8. Convention expenses.
9. Contests and prizes.
10. Credit and collection department salaries and expenses.
11. Prorated general expenses—space charges, printing and stationery, office supplies, telephone, telegraph, etc. (Space charges include portions of building depreciation, insurance, taxes, repairs, light and heat, as well as depreciation, insurance and taxes on the office equipment utilized by the sales division or department.)
12. All transportation and warehouse expenses incurred by the seller in disposing of the goods.

All of the above expenses are necessary either in part or in whole, as the case may be, in order to make sales

and to establish a more stable market for the commodities offered for sale. These expenses naturally have a direct relation to the results accomplished, and that relationship should be established and accounted for as sales (the results) are recorded. But we should not apply, as expenses of selling, a percentage of sales to all sales wherever made. If that were done, and the whole business showed a net profit, then every sale would automatically show a net profit, a condition which we know does not, as a rule, exist; or, if it does, the net profits on different individual sales will vary—and we want to know the variations in net profits on sales by classes. This requires us to obtain a unit marketing cost.

Obtaining a Unit Marketing Cost. In most cases, it is not feasible to obtain a unit marketing cost for each type of product within the salesman's district or territory; for the sales effort of a salesman can seldom be divided as between the products he sells, where he sells more than one product. But, when specialty salesmen are employed to sell one product in their territories, then a territorial unit of product marketing cost can be fairly determined.

While some of the following procedure in figuring the unit marketing cost was covered in the Appendix of Executive Manual 24, we are here determining this cost more in detail for the purpose of selling-expense control.

A manufacturer sells his products in five territories. His marketing costs in each territory were analyzed as follows:

1. Salesmen's Salaries:

(a) Territory 1.....	\$3,000.00	
(b) Territory 2.....	2,700.00	
(c) Territory 3.....	2,500.00	
(d) Territory 4.....	3,300.00	
(e) Territory 5.....	3,600.00	\$15,100.00

2. Salesmen's Traveling Expenses:		
(a) Territory 1.....	\$1,000.00	
(b) Territory 2.....	800.00	
(c) Territory 3.....	900.00	
(d) Territory 4.....	950.00	
(e) Territory 5.....	800.00	4,450.00
3. Sales Manager's Salary.....		5,000.00
4. Sales Manager's Expenses		
(a) Traveling	\$1,000.00	
(b) Office Expenses	2,000.00	3,000.00
5. Advertising Outlay (In charge of sales manager)		10,000.00
6. Credits and Collections.....		6,000.00
7. Prorated General Expenses.....		3,600.00
		<u>\$47,150.00</u>

In figuring his territorial marketing cost per dollar of sales, he necessarily took into consideration the following facts:

His sales manager gave half his time to directing the salesmen (equal attention to each) and the other half to advertising. His direct-advertising appropriation had been spent as follows: In Territory 1—\$900; Territory 2—\$1,100; Territory 3—\$700; Territory 4—\$1,300; Territory 5—\$1,000.

\$2,000 was spent for 6,000 catalogs distributed to territories as follows: Territory 1—1,000; Territory 2—1,500; Territory 3—2,000; Territory 4—500; Territory 5—1,000.

The remaining \$3,000 of advertising expense was spent for trade-journal advertising: \$1,000 in Trade Journal A, and \$2,000 in Trade Journal B. Investigation showed the trade journal circulation was distributed in the five territories as follows:

<i>Territory</i>	<i>Trade Journal Circulation</i>	
	<i>A</i>	<i>B</i>
1	200	400
2	100	400
3	300	100
4	600	200
5	500	300
Total	<u>1,700</u>	<u>1,400</u>

The average number of accounts carried in each of the five territories was as follows: Territory 1—200; Territory 2—300; Territory 3—200; Territory 4—400; Territory 5—500.

Allocating the Territorial Marketing Costs. There are no mysteries in determining the marketing costs in this manufacturer's five sales territories, nor is special accounting technique required; it is simply a matter of common-sense procedure, as follows:

EXPENSES	TERRITORIES				
	1	2	3	4	5
1. Salesmen's Salaries.....	\$3,000.00	\$2,700.00	\$2,500.00	\$3,300.00	\$3,600.00
2. Salesmen's Traveling Expenses.....	1,000.00	800.00	900.00	950.00	800.00
3. One-half Sales Manager's Salary.....	500.00	500.00	500.00	500.00	500.00
4. (a) Sales Manager's Trav. Expense ..	150.00	200.00	250.00	150.00	250.00
(b) Sales Manager's Office Expenses..	400.00	400.00	400.00	400.00	400.00
5. Advertising, and One-half Sales Man- ager's Salary—					
(a) Direct Advertising.....	900.00	1,100.00	700.00	1,300.00	1,000.00
(b) Catalogs.....	333.33	500.00	666.67	166.67	333.33
(c) Trade Journal.....	689.08	630.25	319.32	638.64	722.71
(d) Sales Manager's Salary.....	500.00	500.00	500.00	500.00	500.00
6. Credits and Collections.....	750.00	1,125.00	750.00	1,500.00	1,875.00
7. Prorated General Expenses.....	450.00	675.00	450.00	900.00	1,125.00
Total.....	\$3,672.41	\$9,130.25	\$7,935.99	\$10,305.31	\$11,106.04
\$47,150.00					

Table V. Allocation of territorial sales expenses.

Marketing costs have been distributed to the five territories on the following bases:

- 1 and 2. Salesmen's Salaries and Salesmen's Traveling Expenses direct to the territories in accordance with the salaries paid and the expenses incurred.
- 3. One-half the sales manager's salary (\$2,500) to the five territories equally—one-fifth to each. The sales manager in this case is giving one half his time to sales and one half to advertising. Each territory should be equally burdened because sales management is almost entirely a matter of man control, and therefore the number of salesmen in each territory should be the basis of the expense distribution.
- 4. (a) The sales manager's traveling expense is distributed to the territories on the basis of the traveling expenses incurred by him in each territory.

- (b) Sales manager's office expense is distributed in equal portions to the five territories, assuming that none of this expense pertains to advertising.
- 5. (a) The direct advertising expense goes to each territory as actually incurred.
- (b) Catalog expense is distributed to the territories on the basis of the number of catalogs going into each territory.
- (c) Trade-journal advertising expense is allotted to the various territories on the basis of the circulation of each journal in each territory.
- (d) The half of the sales manager's salary for the time given to advertising is distributed equally to the five territories on the assumption that, no matter what form the advertising takes, his attention is about equally divided.
- 6. Credit and Collection Department expense has been allocated to the territories on the basis of the relative number of customers' accounts in the territories.
- 7. Prorated General Expense has also been distributed in accordance with the relative number of customers, for this expense has a direct relation to the number of customers developed in the territories thru the general and special sales activities.

It is not to be assumed that selling or marketing costs must necessarily be distributed territorially, as above, in all cases. But distribution of these costs as made above constitutes practical procedure in many cases.

Summarizing Territorial Sales and Costs. The territorial sales, cost of sales, and marketing costs may be summarized, in round figures, as recorded in Table VI, showing the balance available for administrative expenses, interest, and net profits.

The danger of accepting totals, or of being satisfied with unit results based upon the entire business accomplishments, is apparent in the analysis of marketing costs per dollar of sales as shown in Table VII. This cost figure for the entire business is shown as \$.1886, whereas the territorial analysis, in which scientific methods of expense distribution have been used, indicates a varia-

EXPLANATION	TOTALS	TERRITORIES				
		1	2	3	4	5
Sales.....	\$250,000.00	\$50,000.00	\$45,000.00	\$48,000.00	\$55,000.00	\$52,000.00
Cost of Sales.....	150,000.00	30,000.00	27,000.00	28,800.00	33,000.00	31,200.00
Gross Profit.....	\$100,000.00	\$20,000.00	\$18,000.00	\$19,200.00	\$22,000.00	\$20,800.00
Marketing Costs.....	47,150.00	8,672.41	9,130.25	7,935.99	10,305.31	11,106.64
Balance Available for Administrative Expenses, Interest, and Net Profits.....	\$ 52,850.00	\$11,327.59	\$ 8,869.75	\$11,264.01	\$11,694.69	\$ 9,693.96

Table VI. Computation of balance available for administrative expenses, interest, and net profits.

	All Territories	TERRITORIES				
		1	2	3	4	5
Marketing Costs per Dollar of Sales	\$.1886	\$.17345	\$.20289	\$.16532	\$.18737	\$.21358
In detail as follows:						
1. and 2. Salesmen's Salaries and Expenses.....	\$.0782	\$.08000	\$.07778	\$.07083	\$.07727	\$.08461
3. and 4. Sales Management.....	.0220	.02100	.02444	.02394	.01909	.02211
5. Advertising Expense.....	.0500	.04845	.06067	.04554	.04737	.04916
6. Credits and Collections.....	.0240	.01500	.02500	.01563	.02727	.03606
7. Prorated General Expense.....	.0144	.00900	.01500	.00938	.01637	.02164
As Above.....	\$.1886	\$.17345	\$.20289	\$.16532	\$.18737	\$.21358

Table VII. Analysis of territorial marketing costs per dollar of sales.

tion from \$.16532 to \$.21358, or a spread of \$.04826 per dollar of sales between the highest and the lowest territories. This variation is wide enough to indicate a possible loss from sales in one or more of the territories.

The effect upon profits is readily discernible: Where the cost is \$.16532 per dollar of sales, the amount available for administrative expenses, interest, and profits is \$11,264.01 on sales of \$48,000; and where the costs are \$.21358 per dollar of sales, the amount available for these same purposes is only \$9,693.96 on sales of \$52,000. Thus, had the volume in Territory 3 been the same as in Territory 5, with the expense factors the same, Territory 3 would have yielded \$12,202.73 or \$2,508.77 in excess of Territory 5. This difference really measures the more efficient performance in Territory 3.

Where More Than One Product Is Sold. In the foregoing table, we dealt with the situation as tho only one type of product were sold. Our conclusions would not be the same if various products having different gross profit rates were sold in all the territories. Altho such a condition would not alter the marketing costs per dollar of all sales, nor the various territorial amounts of such costs, the amounts available for other-than-marketing costs and for profits would be different because of the varying gross profits.

Varying rates of gross profit on different commodities sold in the territories must be considered in the analysis of results obtained in the sales territories. Suppose that the indicated sales of \$250,000 had been composed of \$150,000 sales of Product A for which the cost of sales was 66 $\frac{2}{3}$ per cent, and \$100,000 sales of Product B with a 50 per cent cost of sales, the average cost of sales on both products being 60 per cent.

Suppose further that the sales were made in the territories as follows (the marketing costs remaining the same):

Territory 1

<i>Sales—Product A.....</i>	<i>\$34,000.00</i>	
<i>Less—Cost of Sales.....</i>	<i>22,666.67</i>	<i>\$11,333.33</i>
<i>Sales—Product B.....</i>	<i>\$16,000.00</i>	
<i>Less—Cost of Sales.....</i>	<i>8,000.00</i>	<i>8,000.00</i>
<i>Gross Profit</i>		<i>\$19,333.33</i>
<i>Deduct—Marketing Costs.....</i>		<i>8,672.41</i>
<i>Available for Administrative Expenses, Interest, and Profits</i>		<i>\$10,660.92</i>

Territory 2

<i>Sales—Product A.....</i>	<i>\$31,000.00</i>	
<i>Less—Cost of Sales.....</i>	<i>20,666.66</i>	<i>\$10,333.34</i>
<i>Sales—Product B.....</i>	<i>\$14,000.00</i>	
<i>Less—Cost of Sales.....</i>	<i>7,000.00</i>	<i>7,000.00</i>
<i>Gross Profit</i>		<i>\$17,333.34</i>
<i>Deduct—Marketing Costs.....</i>		<i>9,130.25</i>
<i>Available for Administrative Expenses, Interest, and Profits</i>		<i>\$ 8,203.09</i>

Territory 3

<i>Sales—Product A</i>	\$40,000.00	
Less—Cost of Sales.....	26,666.67	\$13,333.33
<i>Sales—Product B</i>	\$ 8,000.00	
Less—Cost of Sales.....	4,000.00	4,000.00
<i>Gross Profit</i>		\$17,333.33
<i>Deduct—Marketing Costs</i>		7,935.99
<i>Available for Administrative Expenses, Interest, and Profits</i>		<u>\$ 9,397.34</u>

Territory 4

<i>Sales—Product A</i>	\$35,000.00	
Less—Cost of Sales.....	23,333.33	\$11,666.67
<i>Sales—Product B</i>	\$20,000.00	
Less—Cost of Sales.....	10,000.00	10,000.00
<i>Gross Profit</i>		\$21,666.67
<i>Deduct—Marketing Costs</i>		10,305.31
<i>Available for Administrative Expenses, Interest, and Profits</i>		<u>\$11,361.36</u>

Territory 5

<i>Sales—Product A</i>	\$10,000.00	
Less—Cost of Sales.....	6,666.67	\$ 3,333.33
<i>Sales—Product B</i>	\$42,000.00	
Less—Cost of Sales.....	21,000.00	21,000.00
<i>Gross Profit</i>		\$24,333.33
<i>Deduct—Marketing Costs</i>		11,106.04
<i>Available for Administrative Expenses, Interest, and Profits</i>		<u>\$13,227.29</u>

Thus, as contrasted with a condition where only one product is sold in all the territories, the above situation (two products sold in the territories) indicates clearly the effect of variation in gross-profit rates. In fact the results obtained are in the opposite direction; a much larger profit tendency is shown in Territory 5 than in the other territories. While the amount available for administrative expenses, interest, and profit in Territory 5 is 25.44 per cent of the sales in that territory, the percentages in the other territories are:

1. 21.32 per cent.
2. 18.23 per cent.
3. 19.58 per cent.
4. 20.66 per cent.

These comparisons may be tabulated as follows:

AMOUNTS AVAILABLE FOR ADMINISTRATIVE EXPENSES,
INTEREST, AND PROFITS

<i>Territory</i>	<i>Single-Product Sales*</i>	<i>Per Cent of Territorial Sales</i>	<i>Two-Product Sales</i>	<i>Per Cent of Territorial Sales</i>
1	\$11,327.59	22.66	\$10,660.92	21.32
2	8,869.75	19.71	8,203.09	18.23
3	11,264.01	23.47	9,397.34	19.58
4	11,694.69	21.26	11,361.36	20.66
5	9,693.96	18.64	13,227.29	25.44
Total	\$52,850.00	21.14	\$52,850.00	21.14

*Or the effect of using an average gross profit for all sales (disregarding products).

It is now quite evident that we cannot rely upon a general gross profit in calculating the amounts available, in sales territories or districts, for selling expenses, and for administrative expenses, interest, and profits, except in cases where only one type of product is sold.

Where more than one product is sold, the gross profit must be determined for each product in the various territories.

In the case first illustrated, we found that the gross profit on Product A was 33 $\frac{1}{3}$ per cent, and on Product B, 50 per cent. Naturally, those sales territories in which the sales of Product B predominate, as compared with sales of Product A, will show a relatively larger gross profit.

When we first compared the territories, using the general gross profit rate of 40 per cent, we found Territory 3 to be the best (23.47 per cent available for administrative expenses, interest, and profit). But, in the later

comparison, when taking into account the variable gross-profit rates on Products A and B, we found Territory 5 to be the best, because in Territory 5 the sales of Product B predominated; whereas in Territory 3, the sales of Product A predominated, and the gross profit on Product A was only $33\frac{1}{3}$ per cent.

Why Orders Are Costed. The advantages gained thru careful, detailed analysis of gross and net profits are so great that many companies find it desirable to compute the cost of sales on each order that is shipped, and to list costs as well as selling prices, by salesmen, by lines of goods sold, etc. In Executive Manual 59 the methods used in costing were outlined.

Management Questions Stimulated by the Accountant's Findings. Just why the sales of Product B were so large in Territory 5 and relatively so small in Territory 3, are management problems which the above analysis has brought to the fore. These findings cause a manager to ask himself questions such as the following:

1. Should sales efforts on Product A (showing the smaller gross profit) be lessened; if so, can the market be enlarged for a corresponding increase in the sales of Product B (showing the larger gross profit)?
2. If the manufacture and sale of Product A cannot be curtailed, is it possible to work out a plan for reducing the manufacturing cost? Could selling costs be lowered by having one good specialty salesman cover all five territories on Product A, exclusively, leaving the sale of Product B for each territorial salesman to push exclusively and intensively? If this can be done, is the plant capable of producing enlarged quantities of Product B; or is the plant so designed and equipped as to make it advisable to keep on producing Product A as at present?
3. Are the sales of Product A needed in the various territories as indicated, as feeders for Product B; if so, why are the relative sales of both products not proportionate in all the territories? Is the disproportion natural—is it due to local conditions which cannot be altered; or, are the salesmen simply working along the lines of least resistance?

4. Why are the sales smallest in Territory 2 when the advertising cost per dollar of sales is highest in that territory?

Thus, the accountant's figures bring up many important control questions—and when once a question based upon facts arises, the answer can, as a rule, be readily worked out.

The main value of accounting or statistical facts is the extent to which they suggest questions which, properly answered, lead to an increase in net profits.

The statements of facts and the accounting procedure utilized to obtain them, cannot themselves act as administrators; but they act as stimulators to executive action and control; they underlie sound managerial policies and practice.

The Relation of Accounting Facts to Management. Such accounting facts also serve as a check-up on the attainment of managerial objectives. Thus, the executive can tell whether his management is attaining certain objectives, and can also define or establish definite objectives, such as the following sales objectives:

1. A proper and adequate volume of sales in all territories so proportioned between products that the largest profit may result, and so distributed as to deliveries that the production department may work full capacity at all times of the year.
2. Low distribution costs in all phases of marketing activities, entailing a thoro study of local sales conditions, a forceful direction of salesmen, proper selection of advertising media, and careful extension of credits.
3. An adequate selling price in relation to the volume of sales.
4. The fixing of profitable quotas of sales and the establishment of definite expense allotments for the various marketing activities.
5. The proper distribution by products and territories of all marketing costs, so that territorial units of measurement may be created.
6. The installation of budgetary control systems over all selling or marketing activities as part of a general budgeting

system. Frequent check-ups of results with estimates used in the budgets.

7. The proper routing of salesmen in sales districts so that the most economical traveling may be brought about.
8. The listing of customers by localities so that the buying habits of each community may be known as an aid to the salesmen or as basis for the formulation of right sales policies.

Let us continue our analysis of the income statement by following the procedure in deducting administrative expenses.

MANAGEMENT AND THE INCOME STATEMENT

Part V

DETERMINING ADMINISTRATIVE EXPENSES

IT IS difficult—almost impossible in many cases—to control certain forms of administrative expense in their relation to the results accomplished. Furthermore, the management of a business is usually reluctant to appraise itself on the basis of management expense, especially so far as this expense is expressed in the salary of the general manager.

There are few, if any, standards by which management can measure its efficiency in terms of general management expense; but the efficiency of management is often adequately measured by the ratio of net profits to the volume of business or to the business investment.

General management, however, can control the auxiliary administrative costs, because for many of these costs definite standards may be set, especially for salaries.

Classification of Administrative Expenses. If the salary of the general manager is excluded, a more or less effective control over the other administrative expenses may be set up. These auxiliary expenses may be classified, ordinarily, as follows:

1. Salaries of the general office (accountants, bookkeepers, filing clerks, billing clerks, stenographers, etc.).
2. Expenses of the general office (telephone, telegraph, postage, printing and stationery, and miscellaneous petty office expenses).
3. Salaries and expenses of the treasurer's department, and financial expenses.
4. Salaries and expenses of the secretary's office, and corporate expenses.
5. Legal expenses.
6. Taxes.

The general manager also, of course, has supervision and general control over the operations and expenses of sales management, advertising, credits and collections, purchasing, and factory management, but these items are not to be classified under the heading of administrative expenses; they fall either under Marketing Costs or Production Costs.

Classification of Administrative Accounts. Effective control over the administrative expenses requires a clear-cut classification of the accounts, guided by the above analysis of expenses and including any subclassifications that are desirable and necessary.

Thus, the salaries and expenses of the general office—1 and 2 on the preceding page—may be classified somewhat as follows:

1. General Accounting Department.
2. Cost-Accounting Department (altho this charge will be part of Factory Overhead).
3. Filing Department.
4. Billing Department.
5. Stenographic Department.
6. Mail Department.

Under each of these expense accounts will appear the salaries, the postage, the telephone and telegraph, the printing, and the office-supply charges applicable to these respective departmental operations, also all charges for prorated portions of property taxes, insurance, depreciation, repairs, light and heat. The same treatment is also accorded to the operations of the treasurer's and secretary's offices—Sections 3 and 4 in the classification of expenses.

Classifying the Legal Expenses. All legal expense should be carefully watched and controlled. In many cases, resort to the law for adjustment of business difficulties is an indication of weaknesses in certain business policies or in the methods of operating certain departments.

Much legal work in collecting overdue accounts, for example, may indicate weakness in extending credit. Many damage suits for personal injuries in the factory may be traced to the lack of proper safety devices at the machines. Suits brought in connection with purchase contracts may indicate faulty practice in the purchasing department.

It is advisable, always, to classify legal expense according to the causes which give rise to the legal actions.

Very often heavy legal expenses are incurred to protect patents or to counteract infringement suits. Much of this type of litigation can be avoided thru careful analysis of patent laws, proper registration of new patents, and conscientious investigation of existing patents. Bearing in mind the control element in legal expenses, we may well classify them on a departmental or functional basis, as follows:

1. Factory damage suits on personal injuries, back wages, strikes, etc.
2. Collection department—Suits for collection of doubtful or contested accounts.
3. Corporate legal expense arising out of the corporate status in its relation to state and federal laws, or to stockholders.
4. Patent legal expense—
 - (a) For the protection of owned patents.
 - (b) Against external infringement suits.
5. Purchasing or contract department—Suits brought because of nonfulfilment or violation of purchase contracts.
6. Financial legal expense incurred because of nonpayment of bills.

Such a classification of legal-expense accounts aids greatly in fixing the responsibility for legal expenses, and is thus an important factor in keeping these expenses down to the minimum.

Analyzing the Tax Expenses. There is no doubt that the tax expenses also should be well analyzed into separate accounts so that every phase of taxation—local, for-

eign, and national—may be thoroly understood and controlled. Divisions of this may be kept as follows:

1. Local Taxes (State and County):
 - (a) Personal property.
 - (b) Real property.
 - (c) Local state franchise or corporation tax.
 - (d) State income tax (if any).
2. Foreign Taxes (taxes paid to other states):
 - (a) Property taxes.
 - (b) Franchise or corporation taxes.
 - (c) Registration fees, licenses, or taxes.
 - (d) Foreign state income taxes.
 - (e) Taxes paid to foreign countries.
3. National or Federal Taxes:
 - (a) Income tax.
 - (b) Capital stock tax.
 - (c) Excise tax.
 - (d) Stamp tax.
 - (e) Import duties.

With such an analysis of the tax expense into accounts, a consistent and co-ordinated plan of reporting to the various taxing bodies may be developed, and contradictions or disparities in making different tax reports may be avoided.

Tax reports of all kinds should be carefully filed with the receipts for taxes paid attached to them. These receipts are needed if refund claims are contemplated.

Control of Tax Expense. The control of tax expense is important. It requires a thoro knowledge of all the tax laws applicable to the business. Copies of all state and Federal tax laws should be available in their latest form with all amendments and new court decisions which affect these laws. Complete tax information in all its phases and forms may be secured at a reasonable subscription rate from established tax-service organizations.

Tax expense cannot be properly controlled, as a rule, unless some one individual in the business is made responsible for all tax matters. This individual must be

thoroly familiar with the multitude of tax laws. In some large corporations, unless outside tax advisers are retained, one man may well give his entire time to corporation tax matters, particularly to the problem of computing Federal taxes. A new Treasury Department ruling or a late court decision may mean thousands of dollars in refunds. Therefore, it is important that a corporation keep abreast of all changes in the tax laws—and it is usually imperative, from the standpoint of good management, to have one man as a tax expert constantly on the watch for changes in laws and new interpretations thereof.

The basis on which taxes are assessed is of prime importance—whether on the basis of an assessed valuation, the volume of business, the net income, or a capital stock valuation; to compute these bases correctly for tax purposes may result in large savings for a business.

The chief accountant, the auditor, or the comptroller should be made responsible for tax matters, because he, more than any other individual, understands the accounting essentials necessary for making proper tax returns.

How Tax Expense Was Reduced in One Case. Recently a large manufacturing corporation recovered a large sum from the Federal Government because of an overpayment due to a mis-statement of inventory values occasioned by a lack of proper knowledge regarding the simple rule of valuing inventories either (1) at cost, or (2) at cost or market whichever is lower. An expert accountant who really knew tax law discovered the error before it was too late (under the statute of limitations) to file a refund claim. This concern erred because the man who had prepared its tax schedule did not fully understand the second alternative of inventory valuation: "At cost or market, whichever is lower." In the reported inventory on the basis of market values for all inventory items, the total was smaller than the total cost values of all the

items. The man who prepared the schedule had not taken certain large individual inventory items at cost, where the cost was lower than market. Concretely, here was the situation:

<i>Inventory Value as Originally Reported</i>		
<i>Commodity</i>	<i>Cost</i>	<i>Market</i>
A	\$250,000.00	\$300,000.00
B	300,000.00	280,000.00
C	200,000.00	150,000.00
	\$750,000.00	\$730,000.00

The inventory value used was \$730,000, because the total market value was less than total cost value.

<i>Corrected Inventory Valuation</i>			
<i>Commodity</i>	<i>Cost</i>	<i>Market</i>	<i>Cost or Market Whichever Lower</i>
A	\$250,000.00	\$300,000.00	\$250,000.00
B	300,000.00	280,000.00	280,000.00
C	200,000.00	150,000.00	150,000.00
	\$750,000.00	\$730,000.00	\$680,000.00

Thus, the inventory value used on the amended return, forming the basis of the refund claim, was \$680,000, under the correct interpretation of the inventory-valuation rule.

This error occurred in the year 1918, and the company was then subjected to the 80 per cent war-profits tax. The difference of \$50,000 in the inventory valuation resulted in a refund of \$40,000 on the war-profits tax and \$1,200 on income tax.

That is one simple example of how knowledge of the tax laws and of the accounting principles applied in them may result in substantial savings. There are hundreds of accounting principles embedded in the Federal income tax laws and regulations, and a knowledge of them is

necessary in taking legitimate advantage of the provisions of these laws. The United States Supreme Court has held that any legal instrumentality created to reduce taxes, even tho the direct object is a reduction in taxes, must be considered as good business, and therefore thoroly proper.

Functional Classifications of Expenses Are Needed. Just as the division of the tax expense into its various groups permits control over the different types of taxation, and just as the divisions of the legal-expense account facilitate control of the factors and forces that create legal expense, so also do proper subdivisions of all the other administrative expenses, as outlined on page 33, afford a means of controlling the activities of the personnel responsible for these subdivisions.

Expense classifications, especially those of a general or administrative nature, should be functional as far as possible, and should be directly related to the individual executives who supervise the functional activities for which the expenses, as classified, are incurred.

Administrative organization should therefore be along the lines of functional responsibility, so that the expense classifications may be co-ordinated with executive responsibilities. Effective managerial control cannot exist unless a well-defined functional personnel conducts the affairs of business.

Performance and Compensation Standards. Standard compensation rates may be assigned to many office activities, as explained previously in the section on office organization and management. Wherever performance standards can be set in relation to compensation, an ideal form of control is created. The efficiency of the workers in a billing department, for instance, can be gauged by their accuracy and the quantities of bills they turn out; or a voucher clerk's efficiency can be gauged by his accuracy and the number of vouchers he is able to record per

day; and so on. Such measurements of efficiency are possible where the nature of the work is more or less uniform and definite.

Then, when we come to measure results and establish standards for comparison in the more indefinite tasks and functions, we can find other standards of measuring performance. The comptroller's activities, for instance, can be appraised by his ability to render worth-while and prompt reports to the general manager and by his control over his subordinates as expressed in properly balanced accounts promptly completed after the end of each month. The efficiency of the treasurer may be measured by his ability to secure advantageous loans when needed and to keep the cash account adequate at all times in order to meet the demands of all operating departments.

Standards of performance for all administrative work should be set, as far as possible, and the performances should be measured in relation to the expenses they entail.

Thus accounting-and-statistical control in general becomes a matter of analyzing various expenses in relation to results. If the territorial-sales and gross-profit figures in the Cleveland or the Chicago district show a decline from week to week or from month to month, analysis of these figures will show more definitely just where the trouble lies. Analysis of selling expenses or of administrative expenses is designed primarily to reveal the weak spots which are to be remedied, or the strong spots which are to be maintained as such.

Control of business expenses in relation to the results that come from those expenditures is the primary purpose of classifications and analyses of the various parts of the general income statement. But the ultimate objective in setting up an income statement is the determination of the net profit or loss achieved by the business during the period covered by this statement, as previously explained. We remember that from sales we deduct, first, the cost

of sales, then the selling and the administrative expenses. This leaves the net operating profit. The operating profit is the measure of operational activity and represents the full effect of all internal forces working within the business structure. It shows what management has done with all the business factors which are entirely under its control. From this operating profit, there are still other deductions before we have the final net profit, as we shall see in Part VI of this executive manual.

MANAGEMENT AND THE INCOME STATEMENT

Part VI

DETERMINING NET PROFITS

BY DEDUCTING marketing costs and administrative expenses from gross profit, we get what is called the net operating profit. But there may be some nonoperating expense or income items to be deducted from or added to this net operating profit before the final net profit available to the owners is known. Interest paid on borrowed funds, for example, is treated, in accounting practice, as a nonoperating expense.

Interest—A Nonoperating Expense. Interest on borrowed capital, altho it is usually a necessary business expense, is not an operating expense; it represents the cost of others' capital used either for a short or a long period of time.

From the viewpoint of the accountant, actual operating costs are not affected because a business borrows money. The costs of production are in no way increased; no more is paid for materials or for labor; there is no greater depreciation; and advertising and selling costs are not affected because a concern borrows money and pays interest on the loan.

If, from the accountant's standpoint, payments of interest in no way affect operating costs, what is the nature of interest? Is it not merely a part of net operating profits which must be relinquished to those who furnish capital? In other words, when borrowed capital is used, the net operating profit has not been made altogether on the concern's own capital, but on the combined capital of the business owner or owners and the creditors. Therefore, the net operating profit must be the fund from which interest paid for borrowed capital is deducted in the income or profit and loss statement.

The Interest Account and Executive Control. If much money is borrowed and the interest expense runs high, this may indicate that the business does not have sufficient permanent (proprietor's) capital, or that the treasurer (possibly thru poor work on the part of his credit or collection manager) has been unable to induce a prompt collection of receivables. Again the business may be expanding unduly in its physical structure, or it may have too much borrowed capital tied up in inventories.

For purposes of control, the interest account must be studied in relation to seasonal conditions of the business. It should also be classified as to interest on bank loans, loans from individuals, fixed or bonded indebtedness, and purchase accounts.

After interest and any other nonoperating expenses have been deducted from net operating profits—and after any items of nonoperating income have been added thereto—the remainder is the final net profit available to the ownership.

Significant Percentages and Ratios. The final net profit is naturally the item of greatest importance in the profit and loss statement. It tells how much the business has earned on the capital invested, and upon the volume of business. This final net profit is, of course, very significant in relation to the same item on statements of prior periods. This significance lies not so much in comparing the final net profit for different periods, but in comparing the relation of the net profit to other items on the income statement for different periods. Some of these relations are:

1. The ratio of net profits to sales or gross income as compared to previous years' ratios.
2. The percentage of profits on average net worth—net worth representing the total net capital used in the business.
3. The percentage of earnings on the capital stock; and, if two classes of stock exist, the amount available for com-

mon stock after the preferred dividend has been provided for.

4. The ratio of final net profits to gross profits and to the cost of sales.
5. The ratio of final net profits to marketing costs and administrative expenses.

Those five percentages and ratios can also be made with the use of the net operating profit instead of the final net profit as one element.

Not only may these percentages and ratios for the current period be compared with those of past periods or with standard or average percentages or ratios, but also each element in a profit and loss statement may be compared with the same element in similar statements for other periods, apart from comparisons of ratios or percentages, altho usually the single element is compared with the same element for another period in the form of a percentage of the total sales; that is to say, the percentage of each cost or expense item appearing on the income statement to the total of costs and expenses, is studied in relation to the percentages applying to other items and to the same item in other periods.

Comparing Elements in Total Sales. Let us consider carefully the following cost, expense, and profit elements as percentages of gross sales for two fiscal years:

Items	1924	Per Cent of Total	1925	Per Cent of Total
Returns and Allowances.....	\$ 1,000.00	.1	\$ 900.00	.08
Cost of Sales.....	600,000.00	60.0	610,000.00	55.45
Selling or Marketing Costs.....	120,000.00	12.0	150,000.00	13.64
Administrative Expenses.....	100,000.00	10.0	120,000.00	10.91
Interest.....	2,000.00	.2	2,100.00	.19
Final Net Profit.....	177,000.00	17.7	217,000.00	19.73
Total or Gross Sales.....	\$1,000,000.00	100.0	\$1,100,000.00	100.00

These percentage comparisons show a good increase in final net profits in relation to total sales for 1925 over 1924—from 17.7 cents per dollar of sales in 1924 to 19.73 cents per dollar of sales in 1925. Other percentages in

this report, however, show that the profit was largely made by a reduction in the cost of sales from 60 cents per dollar of sales to 55.45 cents per dollar, a difference of 4.55 cents. Furthermore, the good effects of the reduction in costs was partly destroyed by an increase in the selling and administrative expenses which amounted to 2.55 cents per dollar of sales.

Why these increases? is the executive's question. The answer can be found in a more detailed analysis of the marketing costs and the administrative expenses. Such analysis reveals the exact location of the difference and also leads to an accounting for the difference. If the greater selling costs were due to sales-promotional efforts, including advertising, it then may be that the full effects of these efforts will not show up until the next year's sales are recorded, so that some of this expense may be a deferred charge.

Thus, the study of comparative statistics stimulates inquiry, and therefore managerial action—especially if the analysis is carried into the details composing the general groups of expenses and costs.

The method of checking up and controlling the activities of any kind of business, as these activities are expressed in the profit-and-loss account and in the subsidiary analyses of elements composing this account, is essentially the same as for a manufacturing business.

The Retailer's Problem of Control. In order to secure effective control over the operations of a retail establishment, particularly of a department store, the activities should be accounted for by departments—the sales, cost of sales, selling expenses, and possibly the administrative expenses being distributed by departments, with the result that each departmental factor of income and expense is known and can therefore be controlled. Control of this kind is effective for department-store organization in which each department is under the supervision of a department manager or buyer who is responsible for all

departmental activities—buying, selling, inventory control, departmental direct expense and clerk hire.

Distributing Rental Expense to Departments. There are no difficulties in determining and stating departmental sales, cost of sales, selling expense, advertising, and departmental administration; there is no difficulty in fixing the amount of departmental depreciation, insurance, taxes, repairs, light and heat; but when we come to prorate the general fixed charges which are either in lieu of rent or are actually included in rent paid to others—including store depreciation, insurance, taxes, and general repairs—we face some difficulties. These are in the nature of space charges, and some spaces in a department store have more value from a selling standpoint than others—and in a retail store, the sales factors must always receive first consideration. Therefore, in prorating rental cost to departments, such questions as the following come up for consideration:

What spaces are most accessible to the customers?

Is one floor more desirable than another, assuming equal spaces? And is one part of a floor more desirable than another for making sales?

Should the relative values of the merchandise handled be considered in connection with space occupied and with the distribution of space charges?

How shall elevator expense or the fixed charges on stairways and escalators be charged to the various departments?

Is window display expense susceptible to a departmental distribution on some exact basis, or must it be considered as a general advertising cost to be prorated upon some more or less arbitrary basis?

Is it possible to assign certain window spaces constantly to certain departments, thus simplifying the expense allocation?

The answers to such questions will vary in different stores, but in every case it is safe to say that—

Rental costs in department stores should never be prorated to the departments on the basis of relative value-volumes of sales; the basis should always be space occupied, modified by the factor of the relative desirability of the space occupied.

Distributing Other General Expenses to Departments.

With respect to other general expenses, especially those of administration, the following basis of distribution to departments is often recommended:

The general manager's salary and expenses are distributed on the basis of the number of departmental employes, or on the basis of departmental pay rolls.

The general buying expenses (unless buying is entirely a departmental activity) are prorated on the basis of relative departmental purchases over a period of several years.

The credit and collection department expense is distributed on the basis of relative departmental credit sales.

Auditing, accounting, and statistical expenses on the basis of relative departmental sales.

Floorwalkers' expense, on the basis of the number of departments served by each; all departments served by one floorwalker are usually charged equal amounts of his salary.

General office expenses, such as telephone and telegraph, printing and stationery, office supplies, and prorated portions of fixed charges, are distributed on the basis of relative departmental sales.

* * * * *

In concluding our analysis of the income or profit and loss statement, let us bear in mind the fact that all these statements, with whatever subsidiary exhibits and statistics may be required, are prepared in order to determine how the net profit has been made—to reveal the main factors or forces that are responsible for the final result of the period covered by the statement. Analysis of the separate income-producing forces and of all the various expense-creating factors is necessary in order to give management the basic facts that underlie efficient control of a business.

We have now considered the preparation of balance sheets and of income statements, and we know their uses; next, in Executive Manual 75, we shall see the application of this kind of information in the development of sound policies and plans which tend to cause constant improvement in results as shown in the surplus and profit figures on balance sheets and income statements.

CHECK-UP ON PRINCIPLES

Use the following check-up to get the principles of this manual firmly fixed in mind. This will help you to handle the problem which follows. This check-up is entirely for your own personal use, so you need not send it in to the University.

	Check	
	Yes	No
1. The firm of Lawrence & Wilkins sells one product, the Famous Washing Machine, in one territory, the city of Louisville, at an established price. Is a thoro analysis of sales necessary for this particular firm to control its net income effectively?		
2. A retail merchant was discussing the financial condition of his business with his banker. The retailer was emphasizing the fact that he had made a satisfactory profit during the year just closed. "But can't you do better, John," the banker asked, "if you concentrate more on your large-profit lines, and if you eliminate losses which I think you are suffering on some of your lines?" "It would hardly be wise for me to make such a change," the retailer contended. "I have to carry a full line and a full stock. What if I do lose on some things I sell? I make it up on others. All I want to know is whether I'm making a profit in my business." Under these circumstances, was the retailer right?		
3. A salesman for the Wellington Supply Co., of Milwaukee, took an order for a stock item (an item customarily carried in stock) at a price F.O.B., Kansas City. The Wellington Supply Co. was temporarily out of stock on this item and placed a rush order with a Cleveland manufacturer for shipment direct to the customer in Kansas City. Should the freight cost—Cleveland to Kansas City—be charged to the Cost of Sales account?		
4. An analysis of marketing costs on a certain product reveals that the average selling expense per dollar of sales is 19.4 cents. An analysis by salesmen shows that the average selling expense of salesman M is 23.6 cents. Is management justified in concluding from this that salesman M is inefficient?		

	Check							
	Yes	No						
5. Is it desirable and practical for the Hall & Foster Brothers Mail Order House (Executive Problem 73) to establish, for purposes of control, a unit cost of marketing each of the commodities it sells?								
6. The L. D. Smith Wire & Iron Co. has, on the average, \$50,000 invested in raw materials. The president of the firm, Mr. L. D. Smith, advises that a charge of 6 per cent interest on this amount be made to manufacturing overhead. The auditor, Mr. Alexander, opposes Mr. Smith's action. Is the president correct?								
7. "The Fair," a department store in Lorrenton, customarily paid its bills so as to take advantage of the cash discount offered. The Purchase account at the end of the accounting period stood thus: <i>Purchase Account</i> <table><tr><td>Total of Purchases.....</td><td>\$100,000.00</td></tr><tr><td>Less Discount</td><td>2,000.00</td></tr><tr><td></td><td style="border-top: 1px solid black;">\$ 98,000.00</td></tr></table> Cost of Goods.....\$ 98,000.00 Was this correctly done?	Total of Purchases.....	\$100,000.00	Less Discount	2,000.00		\$ 98,000.00		
Total of Purchases.....	\$100,000.00							
Less Discount	2,000.00							
	\$ 98,000.00							
8. Sales of three products are made in two territories. In order to determine the amounts available in these territories for administrative expenses, interest, and for net profit, would you be satisfied to use the Cost of Sales of each product in order to arrive at a territorial gross profit?								
9. It has been asserted that interest on borrowed money is not an operating expense,*but rather a deduction from net operating profit. Is that correct?								
10. A department store manager gives orders that the rent paid for the store be distributed to the departments on the basis of relative departmental sales and that the general management salary and expenses be prorated in the same way. Are these orders in accord with sound principles?								

Executive Problem 74

WHAT FINANCIAL STATEMENTS TELL

Classifying and Interpreting the Balance Sheet and Profit and Loss Statement

UNDER THE LASALLE PROBLEM METHOD



THE facts written large in the white spaces between the lines of a statement are often the most important. To the man who understands the right way—the normal way—to handle accounts and present accounting facts, each deviation from that right way is a question mark. Does it mean inadequate resources or incompetency or trickery?

“Reading” a financial statement requires a knowledge of accounting standards, a pencil and paper, and an acute mind.



Prepared by the Research and Consultation Staff of LaSalle Extension University from an interesting problem which it has carefully investigated and analyzed.

Executive Problem 74

WHAT FINANCIAL STATEMENTS TELL

The following facts, except for the changes in names and in figures, were presented to the LaSalle Consultation Staff for analysis and interpretation.

The Universal Machine Corporation had just appointed C. A. Norman treasurer of the company, and had placed him in charge of its financial and accounting department. It was to be part of Mr. Norman's duty to provide proper operating and financial statements for the general manager and to consult and advise with him as to present and future changes in the financial structure of the business.

Up to October 1, 1925, when Mr. Norman took charge, the accounting had been under the charge of an old man who, tho very faithful, lacked the broad viewpoint of management. Immediately upon his arrival, Mr. Norman called for the latest balance sheet and profit and loss statement. The following documents were handed to him:

THE UNIVERSAL MACHINE CORPORATION

Balance Sheet—December 31, 1924

ASSETS

Accounts Receivable	\$ 95,000.00
Bond Discount	10,000.00
Buildings	120,000.00
Cash in First National Bank.....	7,000.00
Cash on Hand (petty cash).....	120.30
Finished Goods	30,000.00
Finished Parts	6,000.00
Goods in Process.....	12,000.00
Goodwill	50,000.00
Investments	12,000.00
Land Owned	6 000.00
Machinery	80,000.00
Notes Receivable	3,000.00

Office Furniture & Fixtures.....	6,000.00
Patents	23,000.00
Raw Material Inventory.....	17,000.00

Total Assets	\$477,120.30
--------------------	--------------

LIABILITIES

Accounts Payable	\$ 30,000.00
Capital Stock—Preferred	120,000.00
Capital Stock—Common	130,000.00
Mortgage Bonds (10 yrs. due Oct. 1, 1934).....	100,000.00
Notes Payable	40,000.00
Reserve for Depreciation.....	20,000.00
Surplus	37,120.30

Total Liabilities	\$477,120.30
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THE UNIVERSAL MACHINE CORPORATION

Profit and Loss Statement

For the Year Ending December 31, 1924

<i>Sales</i>	\$596,000.00
--------------------	--------------

Less: Cost of Sales

Inventories January 1, 1924.....	\$ 55,000.00
Raw Materials Purchased.....	225,000.00
Labor	110,000.00
Depreciation	10,000.00
Light, Heat, & Power.....	40,000.00
Factory Repairs	2,000.00
Superintendent and Foremen.....	16,000.00

\$458,000.00

Less—Inventories Dec. 31, 1924.....	65,000.00	393,000.00
-------------------------------------	-----------	------------

<i>Gross Profit</i>	\$203,000.00
---------------------------	--------------

Less: Selling and General Expenses

Selling Expenses—

Salesmen's Salaries and

Expenses\$ 52,000.00

Advertising 8,000.00

Miscellaneous 20,000.00 \$ 80,000.00

General Expenses—

Salaries	\$ 75,000.00
Local Taxes	2,500.00
Insurance	2,000.00
Income Tax Paid.....	2,500.00
Discount on Sales.....	7,000.00
Interest	7,000.00
Miscellaneous	6,500.00

\$102,500.00

Less: Discounts on Pur-

chases	4,000.00	98,500.00	178,500.00
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<i>Net Profit for the Year 1924.....</i>			<u><u>\$ 24,500.00</u></u>
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(Note: No dividends were paid in 1924.)

Mr. Norman asked LaSalle to give him its criticism of the statements submitted and to interpret them as far as possible; also to submit suggestions regarding a revision in accounting procedure.

The working papers indicate what should be done with these financial statements so that they may show up, as far as possible, the actual financial condition of the business and the various ratios which are important.

The executive report which will be delivered to you after you have sent in your solution to Executive Problem 74 will show you just how the statements should be presented and the business conditions that they reveal or, in some instances, fail to reveal.

BUSINESS MANAGEMENT

CONTROL THRU BUDGET- ING—Being Executive Manual 75, on Accounting and Statistical Control, in a Complete Plan of Training and Service for Executive Work

By

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CONTROL THRU BUDGETING

Part I

PLANNING FUTURE OPERATIONS

THE aim of efficient management is not only to make profits but also to assure satisfactory and continuous profits thru well-laid plans carried out efficiently; its aim is definitely to control the prime factors that give rise to profit and loss.

Management should know just how, why, when, and where profits have been made and are to be made in operating the business.

This requires careful planning of future operations, with a view toward making sure that the business shall earn the best available or possible net profit.

The Growing Importance of Planning. The need for planning ahead is constantly growing in importance also because the planning of future operations is coming into more general practice; therefore, among competing concerns, those who are not planning ahead find themselves in a more and more disadvantageous position in relation to those who are planning ahead.

Intelligent planning is needed that the costs of merchandising or of production may be cut; that unbalanced relationships between production and sales or between purchasing and sales may be avoided; that all expenses of selling and of administration may be kept low; and that the financing may be kept in step with the needs of the business.

Management can make sure of satisfactory profits only by planning ahead, and thereby controlling all income and expense factors.

It is thru a well-organized system of planning that wastes and leaks can be detected. We know that a business may be prosperous as a whole, and show a good profit, and yet there may be many minor losses in detail

activities, which bulk large in the aggregate. It is important to make each detail activity profitable, and planning should therefore be complete; it should embrace minor as well as major activities.

Planning carried down to detailed operations, with definite control specifications and a constant check of results against the plan, enables management to correct or avoid performance of detail activities that are not profitable.

Survey of Things to Be Planned. The extent and methods of planning in business vary with different types of business organizations. Planning in a financial institution is, of course, not just like planning in a merchandising or manufacturing business; but, irrespective of the type of business organization, effective planning is preceded by a comprehensive survey of the activities to be planned. Thus, in planning sales, a complete survey of past performances and of future possibilities must be made.

A retailer, for example, cannot effectively plan his sales unless he first knows what the past sales have been, departmentally or by lines and items, as the basis for carefully estimating the demand for his goods in the future. His survey will carefully distinguish between staple lines on the one hand and novelties on the other. The manufacturer, when planning sales, will make a survey of his producing capacity. He plans to produce those salable quantities of his different products which will best enable him to secure maximum plant utilization. He will determine how past sales have or have not given him well-balanced production in his shop; and he surveys past sales analyzed by products, territories, and by salesmen, with a view toward making changes in his selling plans that will enable him to produce as well as to sell at lower costs. He will allot to each salesman and to each sales territory definite quotas of sales based upon thoro study of the territories and of the men. He wants

sales which absorb a well-balanced normal-capacity output of his plant.

Sales planning must, of course, be done in the light of facts concerning all operating, selling, and administrative expenses.

Expense and cost surveys are made in order to grant expense allotments to the various departments which will be an incentive to economy and yet allow sufficient amounts to assure efficient handling of departmental or territorial income-producing activities. Sales surveys include such thoro considerations of price and volume as to make sure that the income from sales will yield sufficient revenue to absorb all costs and expenses and leave an adequate profit.

No business planning is complete, nor can it be successfully carried out, unless a full survey is also made of business finances. This survey must show the sources of funds and when these funds are received; it must then show how and when the funds are used to pay for materials, stock, labor, and for all general expenses payable in cash. Such a financial survey will aid management in providing for future cash income and outgo which will adequately meet the demands for cash as they arise.

Planning ahead in business is successful only when every division of business activity is adequately surveyed and the entire operational activities are coordinated in relation to one another, and in relation to the financing.

Scientific Planning of Future Operations. Effective planning of future operations implies scientific procedure; hit-or-miss planning is useless. Scientific planning, as already indicated, starts with a careful survey of the things planned. But scientific planning is not based entirely upon the methods and records of the past, for it is the present and the future that are to be served by planning.

Surveys of past operations and results must be analytical, so that past weaknesses and faults are disclosed—to

be eliminated; for the objective of planning in business is a more successful future. Operating specifications are comprehensively set up in scientific planning; they are not necessarily a replica of past performances, but are a program of expected performances with past weaknesses and faults eliminated. To expect the future to repeat the past is not a progressive viewpoint, and might mean the constant repetition of faulty past policies.

Altho planning must be based upon a thoro analysis of past operations, it combs out past errors in performance and policies when setting up schedules and standards for future performances.

The study of past records and methods serves only as the basis of carefully established forecasts which are made in the light of a very complete knowledge of all angles of the various operations which are planned. Such, in general, is the scope of scientific planning.

Establishing Standards for Future Performance. It is evident that all those who contribute their time and effort to the business, either those in charge of definite activities or those with more general responsibilities, must be called upon for specific information related to their particular functions. This information will clearly indicate the things that have been done. Then, by comparing similar or like activities in which some have succeeded better than others, it will be possible to establish quite definite standards for future performance.

At the same time attainable improvements in future performance may also be set, which will be better than the standards based upon the best in past performances; for there are always possibilities of improvements in handling many activities and responsibilities. These possibilities are discovered thru studies of business activities and responsibilities themselves, studies similar in principle to time and motion studies in manufacturing, as fully explained in the division of this training service on principles of production. Careful inquiry into a sales-

man's route, for example, may readily disclose a more economical sequence for his calls. A thoro study of territorial economic and market conditions may reveal a better territorial credit policy, and may also assist in formulating sales plans. Again, the circulation of trade journals or other advertising media in the various sales territories should influence the direction and extent of advertising thru these channels. Thus—

Planning necessitates a scientific study or survey of all operational factors which contribute to the establishing of the best attainable standards of future performance.

The Place of Budgeting in Planning. Business planning that is written down in the form of daily, weekly, monthly, and yearly schedules of the entire business operations, is called budgeting.

Budgeting is really more than definite or specific planning; it is also a constant and current check-up against accomplishment of the things that have been planned.

Budgeting is a plan which not only schedules the operations of the business as a whole, but also sets up detailed specifications against which performances are measured as they occur day by day.

Budgeting reduces or translates business planning into specific quotas and schedules of operational activities which become standards to be followed or goals to be reached. Thus, budgeting is organized specification-planning which sets up definite performance standards and expense schedules. It is used day by day as a check against the actual performance and expenses. In short, budgeting is business planning that gives management both a detailed and general control of the business.

General Budgeting of Sales and Production. As all well-organized planning, or budgeting, is dependent for its success upon income, and as all expenses in every business must be met out of income, it is apparent that the probable income from sales and from any other sources

must be determined as a whole. It is around a general budget of income that all other budgets must be built.

In retailing, jobbing, and wholesaling, as well as in some financial institutions, the fixing or estimating of the entire income is mainly dependent upon external factors, requiring a comprehensive survey of the income-producing elements only. A manufacturer, however, when estimating or budgeting his sales, must not only determine the market for his goods, but he must also fix his sales quotas on various products with due consideration of production possibilities. The retailer, wholesaler, and the jobber must, of course, consider the availability of the merchandise to be bought, but, at the same time, their purchases can more readily be controlled in co-ordination with changes in their customers' wants or desires.

The manufacturer, however, has a plant adapted for the manufacture of specific products, and that plant with its expensive machinery and equipment must be kept busy turning out definite quantities and kinds of products. As previously suggested, the manufacturer must endeavor to regulate his sales in such a manner that he may secure the best possible plant utilization. If, for example, a manufacturer's plant is equipped to produce two products, A and B, and he finds that in order to get the best possible plant utilization, he should make annually 10,000 units of Product A and 20,000 units of Product B, he must endeavor to set up a sales budget or general quota which will absorb his finished products in the proportion indicated. If he does not budget his sales in accordance with his best production program in previous years, he may have to change his entire sales policies so as to bring about the proper co-ordination between sales and production. Or, if advisable, he may have to change his plant facilities so that he can attain efficient plant utilization without a radical change in sales planning or policy.

Normally, a manufacturer should sell all the products that he is capable of manufacturing without loss in plant utilization. Whether this is done wholly or partly by changes in the plant rather than by better control of sales is a question as to which method will yield the best returns in the long run. Ordinarily, however, sales budgets should be so fixed that all plant facilities are given the maximum effective use.

Now that we understand the general nature and aims of planning future business operations, let us, in Part II, take up in detail the important problem of planning for income; for this, as we saw, is the first important step in establishing budgetary control of a business.

CONTROL THRU BUDGETING

Part II

PROVIDING FOR INCOME

A GREAT many considerations come into play when planning income or sales. These may be analyzed as follows:

1. Present tendencies in income-producing factors:
Do these tendencies point to larger income?
Do they indicate a falling off in certain directions and increases in other directions?
Are the tendencies toward increases or decreases in those income factors which produce larger, or smaller, net profits?
What is the probable net result of the increasing and decreasing tendencies?
2. Conditions out in the market:
Is demand tending to increase or decrease?
Are the economic conditions favorable to sales expansion?
If enlarged volume of sales is indicated, will costs of merchandise or of manufacturing be favorable?
3. Past experiences with product-type sales in the case of the manufacturer or with classes of merchandise sold in the case of the retailer, jobber, and wholesaler:
May it be assumed that at least past experiences will repeat themselves, and to what extent are these past experiences desirable?
What more should be expected than a repetition of past experiences?
4. Departmental calculations in the case of department stores, as to probable sales, expenses, etc., as either an aid to the general planning of income, or as a check on the estimates of management.
5. Salesmen's and jobbers' estimates as checks on the general sales program or plan, as an aid in fixing quotas of sales.

Such are points and questions that must be considered in planning future sales. We can see that—

Planning or budgeting sales calls into play full consideration of things as they have been, as they now

are, and as they should be, requiring a study of market conditions, market tendencies, and the counsel and advice of those whose activities are directly involved in producing income.

The Retailer's Planning Problem. The retailer's problem of planning enlarged sales is different from the manufacturer's problem, altho the same underlying principles apply in its solution. Both problems require analysis. Each wants a larger and more profitable sales volume. That is the final objective; and, in a merchandising business, it falls into four general subdivisions:

1. The determination of the kind of trade which is to be stimulated, i.e., whether the population served is mixed as to buying ability or all of one class. This will determine to what extent sales are to be cash, charge, or installment.
2. The classes of merchandise required and desired by the trade.
3. The types of advertising and window displays that attract the trade.
4. The kinds of store arrangement and displays of merchandise that stimulate sales.

Retail sales planning or budgeting varies with the location of the store and the kinds of merchandise handled. A department store located in the principal business section of a city has a different problem from that of a store located in an outlying district where the population is largely of one class.

The down-town department store must usually, tho not necessarily, cater to all classes of trade—lower, middle, and upper classes with respect to buying power. Therefore, it may have to handle both high-grade and low-grade merchandise; and it may have to sell for cash, on credit, and on the installment plan. A retail store located out near a well-to-do residential section would probably have very few installment sales, but would have to carry a large number of charge accounts; and its merchandise in general would be of rather high grade. The

poorer the class of trade, the greater ordinarily would be the need to sell close to a cash basis or by well- safeguarded installment methods; and the more prosperous the customers as a whole are, the greater would be the volume of charge sales, for prosperous people enjoy extensive credit.

The retailer's planning problem requires a thoro study of the kind of trade served, the credit condition of the customers, and the classes of merchandise handled as related to demand and turnover requirements.

Sales Planning in Manufacturing. Sales planning on the part of the manufacturer is somewhat more comprehensive than retail sales planning. It is not necessarily more difficult, but it requires greater flexibility in the plans adopted. If the manufacturer's goods are sold nationally, each sales locality or territory may have certain peculiarities which should be considered in planning selling methods.

From another angle, however, the budgeting of sales in manufacturing is simpler than in retailing. The manufacturer usually sells relatively few kinds of products, and in many cases his product is a staple article. Therefore, the demand for most manufactured goods is more constant and quotas of sales can be more readily projected. The manufacturer ordinarily sells his products to concerns that have a known use for them, and he may ordinarily limit or extend his line (which is generally all of the same general nature) according to the demand of a particular class of customers. Even in specialty manufacturing (such as millinery and women's ready-to-wear clothing) the manufacturer, as a rule, dictates the changes in styles, and it is the combined task of the retailer and the manufacturer to educate the buying public to an acceptance of the changed styles.

The manufacturer who sells outside of his home town and who employs salesmen to sell his goods, or who sells thru jobbers or by mail, or who employs a combination

of selling methods, must make his sales budget so that the estimates of sales will be distinct for each method of selling. But whatever selling methods are employed, it is necessary for the manufacturer to plan for a sufficient volume of sales:

1. To keep his plant in operation during all seasons of the year, on a well-balanced schedule of production.
2. To receive from this volume of sales enough income to cover the entire costs and expenses of operation plus a satisfactory profit.

Sales planning in manufacturing must be properly co-ordinated with production planning, because the volume of sales should be, as far as possible, predicated upon attaining and maintaining low-cost production.

Selling Price as an Item in Planning. We know that the selling price or prices multiplied by the quantities sold must be ample to meet all costs and expenses, and also yield a satisfactory profit.

Wherever prices can be made upon the basis of the inclusion of all costs, expenses, and the desired profit, no particular difficulty exists if a sufficient volume of sales can be obtained; but if prices fluctuate from time to time, the planning of costs and expenses in relation to the sales becomes very important, and very difficult.

Always under conditions of strong price competition, there is the need for reducing costs and expenses more and more, for, as we saw in our study of economic principles early in this training service, competition for sales tends to cause the price of products to fall.

Establishing the Annual Sales Budget. Naturally, sales planning, as indicated in Executive Manual 74, is based upon an analysis of past sales by products, by territories, and by salesmen, on the part of the manufacturer, and by lines and items and departments on the part of the retailer. If, in manufacturing, the volume of sales has been up to normal plant capacity, then the quantities to

be sold may be considered as fairly well established; if, however, a study of the plant shows that it can produce more, an enlarged sales program would doubtless be desirable if increased sales could be obtained without too great a selling expense.

The planned volume of sales should absorb the output of an even and regular production schedule, as far as that is possible, even tho sales volume may not be entirely even and regular from month to month.

In retailing, if the departmental sales in the past have shown the desired attainable stock turnovers and the store has fully utilized the space available for handling the merchandise and, if in addition the merchandise is largely staple, no particular difficulties should be encountered in budgeting future departmental sales. If, however, considerable irregularities exist in departmental turnover as compared with what could reasonably be expected, necessary adjustments must be made as to the quantities of merchandise to be carried and the methods of sales stimulation.

In manufacturing, the essential requirements in budgeting the total amount of sales to be made for a forthcoming year are:

1. Clearly defined sales territories under the supervision of either the general sales manager or territorial sales managers.
2. There should be a statement showing the expected sales of each salesman in his sales district, indicating the units or quantities and the values of the various types of products to be sold. This will give every salesman a quota of sales for the year. This quota for each salesman, when measured against the salesman's expenses, the expenses of sales management, the expenses of advertising, and prorated general expenses, should be sufficient to insure a good net profit on his sales.
3. Separate sales quotas for each product for each salesman, indicating the quantities and values of sales to be made each month or each week of the year, may be desirable. These statements embrace seasonal fluctuations and, when

combined or summarized for all salesmen, will show the seasonal fluctuations in total sales by products.

4. The quotas set for each salesman and for each and all products to be sold within the various districts and territories may then be analyzed as to dates of shipment. A shipping-quota statement based upon the sales or order quotas is prepared as a guide for production planning. This analysis may come from the sales department or may be made by the production department.
5. The sales-quota detail sheets should, when practicable, be augmented by a route sheet for each salesman. This route sheet contains the names of present customers with room for adding the names of new customers, and spaces for showing the units and values of commodities sold to each customer.

A route sheet simplifies the problem of allocating the direct-selling expenses, and it aids in obtaining unit costs of selling, such as the per-call or the per-town cost. The number of calls made should be indicated on these sheets; and, wherever procedure permits, this form should be made out in duplicate by the salesman. It obviates the need for a number of other reports which the salesmen are often required to make, and it may be combined with the salesmen's expense statements.

6. Where goods are sold by mail, appropriate forms for scheduling such sales by products and by months must also be provided. Mail orders may come from anywhere, but these should be related—if a relationship exists—to the work of the salesmen, or of jobbers, if they are also utilized.

Examples of Quota Statements. The amount of sales planned for a forthcoming period is the starting point of sales budgeting for the manufacturer. He must know what he has sold and what he should sell, and he must know that his plant can efficiently produce the amounts of goods called for by the sales planning.

Assuming that the best possible production plan has been approved and that this plan registers accurately with the seasonal and other sales conditions, he can then set up the necessary sales budgets and quota statements,

GENERAL SALES BUDGET								Year 1926
Month of Year	Product A		Product B		Product C		All Products	
	Units	Value	Units	Value	Units	Value	Units	Value
Jan.	100	\$5,000	100	\$7,500	200	\$20,000	400	\$32,500
Feb.	120	6,000	220	16,500	150	15,000	490	37,500
Mar.	80	4,000	100	7,500	250	25,000	430	36,500
Apr.	70	3,500	150	11,250	70	7,000	290	21,750
May	60	3,000	200	15,000	80	8,000	340	26,000
June	40	2,000	300	22,500	70	7,000	410	31,500
July	100	5,000	200	15,000	80	8,000	380	28,000
Aug.	110	5,500	150	11,250	80	8,000	340	24,750
Sept.	90	4,500	180	13,500	80	8,000	350	26,000
Oct.	80	4,000	200	15,000	100	10,000	380	29,000
Nov.	100	5,000	100	7,500	100	10,000	300	22,500
Dec.	50	2,500	100	7,500	240	24,000	390	34,000
Total	1,000	\$50,000	2,000	\$150,000	1,500	\$150,000	4,500	\$350,000

Exhibit A. Form on which total monthly sales quotas of all products are recorded, giving total annual sales of all products and of each product, also monthly totals in the same way.

TERRITORIAL SALES BUDGET								Year 1926
Month of Year	PRODUCT A							
	Territory 1		Territory 2		Territory 3		All Territories	
	Units	Value	Units	Value	Units	Value	Units	Value
Jan.	50	\$2,500	20	\$1,000	30	\$1,500	100	\$5,000
Feb.	50	2,500	30	1,500	40	2,000	120	6,000
Mar.	40	2,000	30	1,500	10	500	80	4,000
Apr.	40	2,000	10	500	20	1,000	70	3,500
May	30	1,500	10	500	20	1,000	60	3,000
June	20	1,000	10	500	10	500	40	2,000
July	60	3,000	30	1,500	10	500	100	5,000
Aug.	60	3,000	30	1,500	20	1,000	110	5,500
Sept.	50	2,500	30	1,500	10	500	90	4,500
Oct.	50	2,500	20	1,000	10	500	80	4,000
Nov.	60	3,000	20	1,000	20	1,000	100	5,000
Dec.	40	2,000	5	250	5	250	50	2,500
Total	550	\$27,500	245	\$12,250	205	\$10,250	1,000	\$50,000

Exhibit B. Form for recording budget of territorial sales. One form is used for each product. The above form shows Product A only. Like forms would be made up for Products B and C.

TERRITORY 1		SALESMAN'S BUDGET					Salesman X	
							Year 1926	
Month of Year	Product A		Product B		Product C		All Products	
	Units	Value	Units	Value	Units	Value	Units	Value
Jan.	50	\$2,500	20	\$1,500	20	\$2,000	90	\$6,000
Feb.	50	2,500	50	3,750	30	3,000	130	9,250
Mar.	40	2,000	20	1,500	40	4,000	100	7,500
Apr.	40	2,000	30	2,250	10	1,000	80	5,250
May	30	1,500	40	3,000	10	1,000	80	5,500
June	20	1,000	80	6,000	10	1,000	110	8,000
July	60	3,000	50	3,750	12	1,200	122	7,950
Aug.	60	3,000	30	2,250	12	1,200	102	6,450
Sept.	50	2,500	40	3,000	10	1,000	100	6,500
Oct.	50	2,500	50	3,750	20	2,000	120	8,250
Nov.	60	3,000	40	3,000	20	2,000	120	8,000
Dec.	40	2,000	30	2,250	30	3,000	100	7,250
Total	550	\$27,500	480	\$36,000	224	\$22,400	1,254	\$85,900

Exhibit C. Form for recording each salesman's quota by products for each month of the year. Like forms are made out for the salesmen in charge of Territories 2 and 3. This is assuming that each territory has one salesman and that all sales are made by salesmen.

showing total volumes by products, territories, and by salesmen. Exhibits A, B, and C are examples.

Exhibit A shows the general sales budget by months and by the year for all products. It shows, for example, that \$5,000 of Product A sales have been planned for January, 1926. Exhibit B shows how this \$5,000 of Product A is to be sold in the three sales territories. Like forms show how the \$7,500 of Product B sales and the \$20,000 of Product C sales are to be sold in the three territories.

Each territory, in this case, is under the control of one salesman. Exhibit C, therefore, shows how the salesman over Territory 1 is expected to sell the three products in his territory. In January, 1926, for example, he is expected to sell \$2,500 of Product A (which corresponds with the amount shown in Exhibit B), \$1,500 of Product B, and \$2,000 of Product C. Like forms take care of the salesmen in Territories 2 and 3, respectively.

From the General Sales Budget (Exhibit A) which represents how the sales are to be made, or the orders taken, a schedule of monthly shipments can be made out; or Exhibit A may in reality represent such a schedule of shipments. From this schedule, the production budget can be prepared so that the products will be available for shipment as required. If at any time shipments fall off from schedule, the production budget can be modified to give effect to any excess production which may have occurred.

In retailing, the general sales budget is arranged much like Exhibit A. The planned sales are shown by months; but the first distribution of sales would be by departments instead of by products. For each department, however, the expected total sales are broken up to indicate the amounts of the different classes of merchandise to be sold in the department. These departmental sales quotas by classes of merchandise give information necessary for efficient buying and stock maintenance.

As a means of more effective control, the general sales budget and the subsidiary sales quotas, in manufacturing and retailing, also in wholesaling and jobbing, should be further split into weeks.

Sales Budgets and Quotas as Checks against Performance. All general sales budgets and subsidiary sales quotas should be checked against similar statements which show actual accomplishments, in order that variations between scheduled and actual performances may be promptly detected and shortcomings eliminated.

Sales planning or budgeting will not succeed unless those directly responsible for performance—the salesmen or the retail department heads and their sales people—are informed as to the quotas set for them; they must know their goals; in fact, they should assist in establishing the quotas. The quotas must be fairly fixed; they should be reasonably within reach. If so, the

best efforts may be expected; and if the quotas are attained, rewards that impel additional effort may be given.

Management's plan should always include definite steps which tend to impress each man in its organization with a feeling of his full share of responsibility for the success of the business as a whole.

When sales efforts are checked weekly against fairly attainable quotas, any weakness in the activities of the sales force can be promptly detected and as promptly eliminated. It must be remembered that weakness can grow into large proportions if there is no check-up until months have passed. Errors or defects in selling should be caught before they get well started. This is one of management's important uses of budgets and quotas.

Some Factors in Fixing Sales Quotas. Planning for sales may include changes in sales territories or in the organization of the sales department. It does not necessarily mean the continuation of a fixed assignment of salesmen in the territories, or of department heads. Sales territories and departmental arrangements should, of course, be changed and reassignments made as often as these changes will assuredly result in improvements.

In fixing sales districts and sales quotas, it is assumed that a thoro study has been made of the markets, classified by sales districts or territories on a sound basis. A manufacturer of automobile accessories, for example, would not arbitrarily fix his sales territories on the basis of having each territory include a certain number of square miles, for square miles alone would be an unsound basis of division. A better basis would be that of the number of automobiles in relation to a definite area of territory.

If sales are made largely by the mail order method, sales quotas may be planned in relation to the numbers and classes of prospective buyers. This and other methods of selling were covered in the executive manuals on advertising and on sales management.

Whatever the method of selling, sales planning should be based upon a study and recognition of the best sales opportunities.

Such study may often materially modify selling methods or policies or practices. Here, we are interested primarily in the problem of fixing fair quotas for salesmen.

We must consider volume, location, time, and the man. Of these considerations, the personal factor, (the man) is often most important. No plan of budgeting sales for a salesman will succeed without the salesman's cooperation. Personal confidence in the practicability and absolute fairness of the definite quantitative, qualitative, and time assignments must exist in the mind of the salesman. It is for this reason that the salesman should in almost every instance be asked to assist in the fixing of quotas by having a hand in the detailed procedure when expected performances are established. He should feel so far as possible that he is making his own schedule.

Naturally, also, every salesman should be made thoroly familiar with the details of the quota set for him, and he should be informed currently as to how his performance compares with his quota; better still, let him check himself against his quota from week to week. Thus, the use of quotas which have been fairly set and are well known to performers who have had a hand in fixing them, will tend to lessen the amount of direct managerial control required.

SALES PLANNING FOR THE RETAILER

As previously mentioned, sales planning is, in some ways, simpler for the retailer than for the manufacturer; but, in other ways, it is more complicated. Because the retailer sells hundreds of different articles in one territory to many different classes of people, it is difficult to forecast the probable or possible sales of many individual items. Yet sales planning for retail sales is feasible and desirable.

The Basis of Departmental Divisions. Sales in a retail establishment that handles a general line of merchandise, and particularly in a department store (large or small), usually are, and should be, classified in accordance with the departmental divisions of the store; and each department should handle goods that are similar in nature or that bear a close use-relation to one another. It is quite logical and useful, for example, to combine furniture, carpets and rugs, floor coverings, window furnishings, stoves, and house furnishings generally in one large department, because all these lines are sold for the same general purpose. On the other hand, it would be quite illogical to combine men's clothing and baby carriages, or kitchen ware and jewelry.

A close general use or service relationship is the best basis for combining lines and items into a department in a retail store.

When various lines of merchandise, all serving the same general purpose, are made the basis of departmentalization, it is easier to secure department managers who have had specialized experience in buying and selling all those lines, or to train men to perform these activities, for the department manager must thoroly understand the purpose or use of all the lines he controls. Because his buying is for one general purpose or use, he can concentrate his study of the local market upon one general set of wants or desires of the people in that market.

Procedure in Estimating Departmental Sales. Estimates of probable sales should originate with the department manager, who must make a thoro study of the record of past sales of the different classes of merchandise in his department. Knowing the record of sales by items in each line during past months and years, he can then consider any probable changes in the buying power of his prospective customers and set down his estimates of sales in detail. His study should certainly indicate all the important trends of change in sales over a sufficiently

representative period, so that he may decide whether or not the trends are likely to continue, and at what rate.

In retailing, the things to be sold are the identical things that are purchased. Therefore, whenever certain sales tendencies vary from the projected course, the buying can be readily modified to meet the new conditions. This is a fundamental point of difference between manufacturers and merchants.

Following is an example of the kind of detailed sales estimating that a department manager can make in a house-furnishings department:

1. *Furniture*

(a) Living-room furniture and suites

(1) January	\$000
(2) February	000
etc.	000

(b) Dining-room furniture and suites
(As above)

(c) Bed-room furniture and suites
(As above)

(d) Mattresses, box springs, pillows, etc.
(As above)

2. *Carpets, Rugs and Other Floor Coverings*

(a) Oriental rugs (large, small, and runners)

(b) Domestic rugs (finished and carpeting)

(c) Linoleums
etc.

(Division by months, etc., as in 1.)

3. *Window and Door Furnishings*

(a) Shades (plain, lace, and fancy)

(b) Curtains and drapes
etc.

(Division by months, etc., as in 1.)

4. *Stoves and Fire-Place Furnishings*

(a) Gas stoves

(b) Electric stoves

(c) Wood and coal stoves

- (d) Andirons
- (e) Fireplace accessories
etc.

(Division by months, etc., as in 1.)

Each estimate of probable sales for the period covered should be recorded by months, so that the seasonal conditions may be clearly recognized and so that the actual sales may be checked against the estimates each month.

The Need for General Control of Planning. Altho the department managers should supply the sales estimates, the comparing of actual sales with the estimates should be in the hands of a responsible executive who will also see that the entire business budgeting is efficiently carried out. In some concerns this officer is known as the budget supervisor, or he may be the comptroller or the general manager himself.

The planning and carrying out of plans will succeed best when the planning officer or general manager co-ordinates all the planning and checks the actual accomplishments against the quotas set.

This principle does not mean that the department heads should not know the results as compared with their plans. On the contrary, it is desirable that they be kept informed at all times, for they are required to account for variations from expected sales. But a department manager is usually too busy to watch all his steps as he is taking them; he cannot be expected to keep the detailed records required in the control of his department. The assignment of record keeping to department managers in a retail store usually means no records at all.

A definite planning unit or officer under the control of the general management should exist wherever planning assumes relatively large proportions, to insure constant active control which incorporates and expresses the managerial policies and sees that these policies are carried out in departmental management.

Planning for Increased Sales. To plan increased sales in a retail business involves, in addition to a thoro study

of trends as revealed by past analysis, a complete investigation of selling prices, competition, fluctuations in prices, store location, population served, advertising, window display and store arrangements, and of local employment and wage conditions. Past experience is naturally the best basis for sales forecasts, but the planning should include at least normal increases in sales, if not special increases that exceed past trends of increase in certain lines and items.

Planning for increased sales is much more difficult in some departments than in others. There are necessarily extensive fluctuations in retail prices on many classes of merchandise. This difficulty is often augmented by increases in the character and amount of competition, and by constantly changing tastes and desires for new styles. In jewelry, ordinary clothing, house furnishings, shoes, furniture, toilet articles, and such lines, price fluctuations are not so great; but in fancy dresses, suits, cloaks, millinery, and many other lines, there are constant style changes. Planning is most difficult where there are frequent and sudden style changes.

In retail sales planning, the buying of merchandise subject to style changes must be rigidly controlled to gain a close co-ordination with the actual conditions.

CO-ORDINATING SALES, PRODUCTION, AND PURCHASING

Efficient sales budgeting is co-ordinated with the activities which give rise to the commodities that are to be sold. In retailing, this activity is confined to buying; in manufacturing it is production, and purchasing as related to production.

In retailing, we have seen that sales estimates are based very largely upon past experience; while in manufacturing, we see that the capacity and nature of the plant and equipment must also be considered so that planned sales will give the best possible utilization of the plant and its equipment. A manufacturer is not able

to change his sales program arbitrarily from one product to another, unless his plant happens to be equipped for making the new product. Ordinarily, he has to plan his sales without much thought of changing his product or products should something happen to make his sales more difficult to secure.

Co-ordination of sales and output in manufacturing is primarily a problem in adapting sales to production facilities, altho production schedules in many cases should be kept flexible.

A manufacturer can seldom afford to make extensive changes in his plant and equipment just because a new product would result in larger sales. He can ordinarily better afford to put more selling effort back of the product or products which he is prepared to make. Yet he must avoid the mistake of battling for sales against odds that are too great. If the trend of demand for his products is decidedly downward and if the causes of this trend indicate its continuance, he, of course, had better plan a gradual shift to other products.

On the other hand, his market conditions may be extremely favorable for a large and rapid increase of sales. If so, his sales planning must avoid securing so great a sales volume that the capacity of his plant will be overtaxed to the extent of running up his costs of production beyond the point of diminishing returns, as explained early in this training service.

Co-ordinating Sales with Buying. The merchant's control of his stock of salable goods is more flexible. At times, he may be overstocked on certain goods, but he can control his buying to fit oncoming changes in demand. By careful study of trends of change in demand, he can maintain close co-ordination of his sales and purchases. Overstocking of merchandise is usually confined to a few individual lines or items at any one time, and the losses from this source need not be great if the merchant fully realizes that—

Effective planning of sales in close co-ordination with buying is the basic principle of success in merchandising.

Shortening and Co-ordinating Production Schedules.

Turning again to the manufacturer's problem of co-ordinating sales and output, we find that altho his plans contemplate a relatively long period of time, yet he can break up this period into short-time production schedules which, when properly co-ordinated, will have the same effect as long-time schedules, and need not interfere with the smooth running of the plant.

If his production is on the basis of co-ordinated short-time schedules, he can more readily change these schedules in accordance with changes in the sales. This procedure is a wise one, altho it might possibly mean at times a temporary shortage of goods. A notable advance in recent years has been the closer co-ordination of production with sales in many lines of industry. As sales rise or fall, output rises or falls. The consequently better maintenance of the supply-demand balance makes for greater stability in the industry.

Procedure in Correlating Output and Sales. The first step in planning production in proper correlation to sales, is the preparation of a schedule of product deliveries or shipments, as and when the products will be wanted by the trade as specified in the sales orders, or as estimated by reference to past records.

All seasonal variations as to quantities and kinds of product to be shipped must be carefully observed in scheduling production. The finished-goods inventory must show the goods to be on hand when the shipments are to be ordered out. The manufacturer has a double problem:

1. He must produce in proper quantities to meet specified shipments, and must therefore perfect a careful plan of production.
2. He must purchase the raw materials in proper time to meet the requirements of his production schedules.

In addition, he must, of course, plan for ample labor and for plant preparedness in general. How to do these things was fully covered in the section on principles of production.

Planning for Inventories. Both in manufacturing and in retailing, inventories should ordinarily be carried at a point where the greatest turnover will result.

The manufacturer's finished-product inventory gets its turnover thru sales in much the same way that merchandise sales give the turnover of mercantile stocks. But the manufacturer must also secure the proper turnover of his raw materials, and this he accomplishes by means of the best plans for producing his finished product. The purchasing of raw materials is guided primarily by the production schedules. There are, of course, other factors to be considered, such as price trends of materials to be purchased and quantity discounts. But this problem has already been fully treated in the section on production in this training service.

Next, in Part III, we shall make an analysis of the problem of providing for current expenses by establishing control thru budgeting expense accounts.

CONTROL THRU BUDGETING

Part III

PLANNING COSTS AND EXPENSES

THE planning of the costs and expenses of manufacturing and of merchandising will be ineffective unless it is tied into sales or income budgeting, for—

Always, the final objective of planning is to insure satisfactory profits just as far as that is possible.

It is the expected or desired net profit which must always receive consideration when the costs and expenses of the various activities which combine in earning the net profits are planned and budgeted.

Handling the Uncertain Factors in Planning Expenses.

In planning costs and expenses we deal with a number of readily established factors and with others that are not so readily established.

In manufacturing, for example, assuming that factory operations are well standardized, the costs of production are pretty well fixed on all the products. But this cannot be said of all the selling, administrative, and financial costs. In retailing, on the other hand, we may say that the selling, administrative, and financial expenses are readily measurable and that the uncertainties center largely around the selling price and the cost of purchases.

In both manufacturing and merchandising, the uncertainties must be recognized so that their effects may be minimized when they come into play. These uncertain factors need not be estimated at the start of the planning process; but as they come to the fore, the planning should be correspondingly modified.

Planning as a whole, if subdivided into short periods of time—any one of which can be modified to meet sudden

changes—will generally help to overcome the effects of the more or less uncertain factors in expenses, selling prices, or in the costs of goods purchased. These uncertainties must therefore be disregarded until they come into play—recognizing at all times, however, that they may come up, and that proper provision should be held in reserve to take care of them as and when they occur.

Profits as the Basis of Planning Costs and Expenses. As all costs and expenses, plus the net profit, must be realized from the operating income, and as it is desired that the net profit be up to or above a certain minimum, the planning of costs and expenses is generally based upon the amount of net profit which it is deemed satisfactory for the business to make.

What the net profit should be depends on a number of circumstances variously affecting different types of business. But there is one principle which holds good in any business:

Net profits must be sufficient to enable a business to pay a normal return on the investment, and to provide sufficient additional funds to take care of normal expansion and to meet the usual periods of depression which come from time to time in almost any business.

In most cases, the base upon which profits should be calculated is the investment; but whether this investment should be the capital originally contributed or the varying net worth of a business, is a debatable point. Net worth as a basis for estimating the amount of profit desired, would ordinarily mean the sum of the original capital contributed and a normal amount of profits retained in the business as additional capital.

Sometimes, however, net worth grows out of all proportion to original capital investment as the result of a policy of nondistribution of accumulated profits to the investors; and a profit calculated upon that base would doubtless be an unreasonable rate of return to expect—unless the accumulated surplus had been quite com-

pletely invested in an enlarged plant or other operating facilities, or in the stock of subsidiaries. Or, in some instances, profits may have been retained in a business in order gradually to build up a fund to retire a capital debt or to acquire in time a valuable leasehold or other property, the ownership of which would materially reduce certain operating expenses. Such accumulations would be regarded as legitimate; but whether or not they, combined with original capital, would afford the proper base for an estimated profit on sales, is another question.

The Basis for Estimating Desired Profits. Because of the variables in net worth, it would seem to be true that—

The most logical base for planning an anticipated profit is the actual owned capital and surplus used in the business operations.

Because invested capital is permanent in a business, it is a better base upon which to calculate a profit percentage than sales. Sales values fluctuate and prices change, so that an anticipated rate of profit on planned income would not in any way effect a consistent control of the expenses of the business. A stated return on permanent capital should nearly always prove satisfactory and, when deducted from the anticipated sales, would give the total amount to which all costs and expenses would have to be limited.

But the correct solution of this problem depends upon the nature of the business. If the business is one in which new equipment must be frequently provided at heavy cost, the answer would be different from that for a business where fixed assets would not need frequent additions or changes. Again, some businesses of a professional or semiprofessional nature, which sell personal services, may have practically no invested capital at all; their investment (which is negligible) affords no adequate base for calculating what would be satisfactory profits for them. Therefore—

If capital is the chief source of obtaining income, the capital investment may be used in profit calculations; whereas if personal service is the source of income, a percentage of the gross profit may be fixed as representing a satisfactory net profit.

In personal-service organizations, where the income is largely from fees or commissions, the operating costs and expenses are usually small and readily determinable; they consist almost entirely of rent, clerical salaries, and of general office expenses such as stationery, printing, telegraph, telephone, and possibly of traveling expense. If the profit estimate then is a certain percentage of the gross profit, the remainder of gross profit can be budgeted for the operating expenses.

Establishing a General Budget for Operating Expenses.

If sales have been quite accurately budgeted and the estimated net profit on the investment has been fixed, the difference between these two items may be considered as the general budget of all costs and expenses.

In a well-organized manufacturing plant, the costs of production are quite accurately determinable in advance; for costs in such plants have been standardized. If then, the sales estimate is at hand, if cost of sales (manufacturing costs of goods sold) is known and if net profit desired is estimated, it is a simple matter to fix the total budget for selling, administrative, and financial costs and expenses.

In retailing, where at least a general cost of sales (cost of goods purchased for resale) in relation to selling prices is known, much the same procedure can be followed. In the case of either a manufacturer or a merchant whose sales budget has been fixed at, say, \$1,000,000 for the coming year, whose cost of sales is 60 per cent of sales income, and whose planned profit is put at 12 per cent on a capital of \$500,000, the general budget for selling, administrative, and financial costs and expenses would be computed as follows:

Sales	\$1,000,000
Less: Cost of Sales (60%).....	600,000
Gross Profit	\$ 400,000
Planned Net Profit of 12% on \$500,000.....	60,000
General Budget for Operating Expenses.....	\$ 340,000

The \$340,000 in this case would have to cover selling, administrative, and financial expenses, including interest on borrowed funds.

Budgeting Fixed and Variable Expenses. In planning the detailed budgets that make up the general expenses, it is possible to set down certain fixed items right at the start, and then to cut or increase here and there in the items that are uncertain, as the general policies may dictate.

In both a manufacturing and a mercantile business, the expense items that are more or less fixed are the following:

1. Selling salaries and traveling expenses (including sales management).
2. Office salaries and expenses of the sales department.
3. Executive salaries and expenses.
4. Financial salaries and expenses (including the credit and collection and the general accounting departments).
5. General office expenses for the administrative and financial departments.
6. Interest on capital indebtedness (bonds and mortgages).
7. Interest on average amount of temporary loans from banks, etc.

When budgeting the above group of relatively fixed expenses, it should be remembered that the amount allotted to each is to be based upon calculations of each expense item as it should be rather than as it has been or stands at present. Budgeting, as heretofore indicated, implies the best performance in relation to expense.

After the relatively fixed expenses have been budgeted,

the remaining funds are then allotted to the variable expense items, including such items as:

1. Advertising.
2. Sales promotion.
3. Legal expense.
4. Contingencies of various kinds.

Any necessary adjustments are usually easier to make among the variable items. But the main point here is that the safest planning or budgeting of operating expenses starts with the amount of total budget of sales or gross income, deducts therefrom the planned cost of sales, thus determining the gross profit, and finally sets a figure for operating-expense budgets. This figure is the difference between the gross profit and the desired net profit on investors' capital.

Planning the Cost of Sales. The cost of sales is, as we know, either the cost of manufacturing goods that are sold or the merchant's cost of the goods he buys to sell.

We have covered previously the complex problem that confronts the manufacturer in planning his cost of sales; and the retailer must plan his budget for purchasing merchandise so as to attain a satisfactory stock turnover, giving full consideration to the seasonal factors in selling merchandise.

The manufacturer, in planning his cost of sales, has more to think about than the funds required for purchasing his raw material. He must not only maintain, thru proper purchasing and perpetual-inventory control, the right quantities of stores for meeting his planned production schedules, but also he must, with equal care and precision, plan for the quantity and quality of labor, as and when needed to produce the commodities he plans to sell; and he must plan for his auxiliary supplies for his power plant, for machine and tool repairs, and for the manufacturing operations themselves. His plans must likewise include any new equipment needed to carry out his production plan.

The manufacturer's cost system, if efficient, will give him the amounts of factory overhead chargeable against the various products to be manufactured. But some of the items of factory overhead call for current outlays of cash. Among these items are the costs of factory superintendence, indirect labor, repairs, replacements, maintenance, factory taxes, factory insurance, and factory clerical help. All such expenses must be paid in cash, and they therefore enter prominently into the financial budget of receipts and disbursements.

Control of Factory Overhead. As previously explained in this training service, a cost system provides for accurate allocation of factory overhead to the products as they pass thru the plant. But whatever the plan of allocating factory overhead may be, factory control always aims to reduce factory overhead to a minimum—unless increased overhead would result in lower direct-labor costs.

An effective plan of production requires the use of the best and most economical factory operations, the best possible arrangement of machines and sequence of processes, standardization of labor operations and costs, economical production of power, light and heat, and efficient supervision thru the works manager, the superintendents, and the foremen. All these matters and detailed consideration of the various methods of allocating factory overhead were explained in the section on principles of production.

The Main Requirements in Controlling Production. Here, however, we should note what are the main factors in production planning from the viewpoint of control. These requisites are:

1. An estimate of the plant capacity and plant composition in relation to planned sales and deliveries—to make sure that required shipments will not be delayed and that the plant is properly equipped to make the products that are sold.

2. Equalization of the monthly output should be attained as nearly as possible so as to avoid the cost of idle-plant capacity. Shipments may sometimes be regulated to conform with an equalized production schedule. There should be constant co-ordination between sales and production planning.
3. The required output should be determined upon, and stated in terms of finished products by months or weeks.
4. Raw material inventories, which will meet production schedules month by month, should be determined upon and stated both in units and dollars.
5. There should be an estimate of direct labor required in hours and dollars, as related to the various factory operations in production, and routing control should furnish a schedule of the sequence of these operations as related to the labor element.
6. After factory overhead has been estimated for the planned production, a predetermined unit cost of overhead per operation, per machine-hour, or per man-hour, can be fixed.
7. Production should be scheduled by months or by other operating periods, and all inventories should be controlled by maximum and minimum standards. Relatively short production schedules make for flexibility in the event of any unexpected changes in the demand for manufactured products.

Purchase Planning for the Retailer. In the efficient planning of purchases for a retail business, the following considerations are vital:

1. A close relationship or co-ordination must be established between the planned sales and the purchasing, with careful attention to seasonal changes.
2. Purchasing should always be cautious, with flexible adaptation to any changes or trends which appear in the sales; this is especially necessary in order to prevent overstocking on lines in which styles change frequently.
3. Quantity buying is usually advisable for staple lines of relatively small unit value, in order to get price advantages.
4. Maximum and minimum quantities should always receive consideration so that the store will never be out of stock on items for sale or for display; furthermore, retail customers want their purchases delivered "right away," and

customers are lost if the desired merchandise is not available at once. The study of buying habits and seasonal conditions is, therefore, of very great importance. But, always, the quantities carried should, as far as possible, be in conformity with the best turnover requirements.

5. A perpetual-inventory system is necessary in a retail store, and the balances of merchandise on hand should be checked—daily in some instances, and frequently in all cases—against maximum and minimum indexes and unfilled purchase orders.

THE PLANNING OF MARKETING EXPENSES

Considerable attention was given to the manufacturer's selling costs in a previous manual, including a method of analyzing sales and the cost of selling by territories and by products. Certain portions of administrative expenses were placed in selling costs, including a number of items over which the salesmen in the territory have no control, items which are included in *statistical* surveys of sales when the object is to arrive at a territorial net profit from sales. Here, however, we are concerned with budgeting the more or less direct selling or distributing costs in both manufacturing and retailing.

Planning Marketing Costs in Manufacturing. In planning the distributing or marketing costs of a manufacturer, the following procedure is recommended:

1. The salesmen, who usually should have a hand in working up the sales quotas, may also be of considerable assistance when the territorial direct-selling expense budgets are being worked out; not that the salesmen shall say what these expenses should be, but that they, knowing the conditions in various towns, status of customers, etc., will contribute information on which expense estimates can be more intelligently made.
2. Traveling expenses should be budgeted for each month, or for each week, if necessary; and, as far as possible, the men should be properly routed. The salesmen must then be checked frequently as to their sales quotas and their traveling expenses. Variations from quotas should become known as they occur, and the proper kind of co-operation

should be provided from the home office to bring results into accord with the planning.

3. Advertising in the territories should be planned in a number of ways, of which the following are suggestive:
 - (a) Local territorial advertising allotments should be based largely upon the relative number of prospective customers in each territory and the possible volume of business which may be expected from them.
 - (b) Advertising appropriations for specific circulating media should follow the circulation records in the various territories, modified as need be by the character of the readers.
 - (c) Catalog advertising expense should be planned in accordance with the relative number of buyers in the territories to whom catalogs are to be sent.

The salesman is very often in a position to assist in this planning, and the credit department may also help.

Communications and directions to salesmen with regard to their expense budgets and sales quotas should naturally come from the sales manager, but those in charge of the administration of the sales and expense planning should have a check on this part of the sales manager's work—for general management should make sure that corrective action immediately follows any variations from the planned results.

Planning Selling Expenses in Retail Establishments. The selling expenses of a retailer embrace the activities of sales clerks and other selling functions; and these expenses are planned with reference to the departmental and general activities.

Planning for future selling expense rests mainly upon an analysis of past departmental selling costs in relation to past accomplishments in the departments.

Departmental sales are, of course, not the determining factor in budgeting clerk hire, because, in some lines of merchandise, altho the sales volume expressed in dollars may be great, very few sales clerks are required. Again,

there are some lines of relative low value that require very many sales people. But—

The number of sales people allotted to a department should be based, to a large extent, on the amount of net profit which the department is planning to make on a stipulated volume of sales.

Of course, a sales clerk may not sell his proportionate share of the departmental sales quota, but if the entire departmental sales reach the quota fixed, the condition would be satisfactory. In retailing, clerks can hardly be expected to be individually responsible for definite portions of the departmental sales quotas.

After giving due consideration to the need and desirability of employing good sales clerks, the departmental budget for this expense is usually limited to an amount which remains after all other expenses have been budgeted departmentally and the desired departmental profit has been determined. Such procedure, however, must not interfere with the retention or the employment of efficient clerks, because, after all, sales are the important consideration and it may take good sales people to secure the amount of sales planned. Also, as a rule, having fewer and better clerks is more desirable than having more but less efficient clerks. Thus the policy of preferring quality rather than quantity of selling service may permit planning that limits clerk hire to the desired amount fixed by a budget worked out as indicated above.

Assume that Department A in a retail store has been assigned a sales quota of \$100,000 and a net profit of \$10,000. If it is found that \$80,000 is positively required to cover the cost of sales, the department manager's salary and expenses, advertising and window display, general store expense, and prorated administrative and general expense, then it is apparent that \$10,000 remains for clerk hire. This sum is then budgeted for clerk hire in a manner consistent with a policy of employing competent sales clerks. If this cannot be done, then the desired profit must be cut or the sales quota increased.

The most important thing in retail store planning is the predetermined quota of sales, and it is essential that this calculation be as nearly accurate as possible, even tho it must be frankly admitted that the predetermination of sales in retailing is beset with many difficulties and uncertainties.

PLANNING FOR ADMINISTRATIVE EXPENSES

Planning administrative expenses is usually a process of elimination. After all other costs, expenses, and the desired profit have been determined, the remainder represents the allotment for administrative expenses. If, out of this allotment, certain amounts can be immediately applied to certain specific administrative charges, the residue may then be considered available for the more or less indefinite general expenses, and precautionary measures should be adopted to keep these expenses within the bounds of this residue. Among the more specific administrative expenses are:

1. President's and general manager's salaries.
2. Salaries of a number of other officers.
3. Many of the clerical salaries.
4. Fixed charges prorated to the general office such as depreciation, insurance, taxes (or rent), light and heat, etc.
5. Various departmental salaries, such as for department heads in department stores, chief accountant, credit and collection manager, etc.

If, after providing for the fixed items, it is found that little is left for general office expenses, such as telephone and telegraph, office supplies and stationery, postage, printing, etc., cuts in the allotments for the fixed items or in other items must be made, and in this process the constructive ability of the general manager will be tested. By means of this process, management may sometimes find that its own allotted compensation is somewhat out of line.

* * * * *

Now, having budgeted all costs and expenses, the next problem is that of planning the financing of the business so that income and expenses, plus profits, will balance.

CONTROL THRU BUDGETING

Part IV

THE FINANCIAL BUDGET

IN ALL budgetary procedure there must be a close tie-up between income and expenses; in other words, income on one hand must take care of costs and expenses (outlay) on the other hand; and the financial budget is the means of accomplishing this.

The financial budget is, therefore, not a departmental budget, but it is a budget which co-ordinates, in a plan of financing, the estimated receipts with the estimated expenses of all departments.

A financing plan should be broader than a mere cash budget; it should be a funding budget, i. e., it should provide not only for cash outlays but for accruing or accumulating expenses which will have to be met by cash outlays later on.

Financial planning of this kind may, from time to time, lead to temporary cash surpluses; but such a situation is not undesirable, because excess cash may be put into liquid income-yielding securities.

A "funding plan" as distinguished from a cash budget, gives full consideration to such items as accruing depreciation, taxes, repairs, etc. Altho we do not pay for depreciation month by month, yet we do continuously secure the services of the depreciating units, and the cost of those services should be provided for currently. We should not permit the "bill" for depreciation to keep on accumulating, and then find, when replacements must be made, that no funds are available. Again, if taxes are payable once a year, why not build up a cash fund month by month to meet this liability? Repairs occur irregularly, but they ordinarily benefit an entire period of operations.

Balancing Income and Expenses. Income and expense are balanced by preparing summaries of the depart-

mental budgets showing both the amounts and the time of receipts and of expenditures; and a chronological schedule is prepared which shows the estimated receipts and cash disbursements.

In any business, the payments for purchases should be chronologically arranged, and should be related to the cash which is to be on hand at the time. Pay rolls must be co-ordinated with the cash receipts in the same way. Advertising outlays must be related to the cash as it comes in, and so on. In providing for all these outlays, it may be necessary to borrow funds if the cash receipts do not suffice from time to time. This problem was covered in detail in previous manuals on financing a business.

Securing an Adequate Inflow of Cash. The real question in financing is, How can Accounts Receivable be made to yield cash so that the determined and fairly well-fixed monthly disbursements may be promptly met? A general answer to this important question is that—

The credit and collection activities, as well as periodical borrowing, must be so scheduled and planned that the cash will flow into the business as it is needed to meet the budgeted expenses.

In lines of business that have no marked seasonal conditions and where credit has been carefully extended, collections may be expected to come in quite regularly to meet the ordinary current expenses. But in most lines of business there are seasonal fluctuations, with constant ups and downs in collections, while purchases vary from month to month, the pay-roll fluctuates, and selling expenses are now high, then low. If these irregular conditions are fully recognized, and if the irregularity is fairly consistent or seasonal, provisions can be made for the retention of cash when collections are heavy in order to meet the demands for cash when the expenses become heavy in relation to current collections.

We saw, in the manuals on financing a business, how

budgetary preparation and planning should embrace expansion plans, with particular care in providing for increased operating expenses which come from expansion. We saw that expansion should ordinarily be planned in conformity with ability to provide sufficient working capital.

In most cases, a business should expand rather slowly and conservatively, taking every precaution not to increase unduly either its fixed or current expenses.

Balancing the Budgets. Budgets in business must represent a unified and properly balanced whole. After the sales and income have been planned, by certain periods, as dictated by the status of the particular business, the expenses of all departments must be scheduled and separately budgeted in proper juxtaposition to the income, because—

Control of expenses in a business lies in well co-ordinated control of expenses within and between departments.

Co-ordinated budgeting is the heart of business control, and the financial budget is the instrument thru which the entire income-producing activities and estimates are co-ordinated with the costs of production or purchasing and the expenses of administration and selling, as fully explained in the section on financing a business.

CONTROL THRU BUDGETING

Part V

BUDGETARY CONTROL AND ITS LIMITATIONS

IN PLACING the responsibility for budgetary control, the first step is to analyze and define this responsibility, then to assign the responsibility to an executive who is to report directly to the general manager; or who, in some cases, is the general manager himself.

A budget system is, in reality, the very essence of managerial control, and covers the entire range of management activities.

A budget embraces all managerial policies, and its administration is the fulfillment or accomplishment of these policies.

To see that managerial policies, as expressed in the budget, are fully carried out, requires a direct knowledge of all business operations, as these register or do not register with the budget; consequently, the budget officer usually is either the manager himself or some officer acting for him who will assist in the administration of the budget.

Comparing Performance with the Budget. To make budgetary control effective requires virtually a day-by-day comparison of actual performance with the general budget, with the detailed budgets, and with all the various quotas. Official authorization is required for expenditure of the amounts specified in the budgets of expenses.

This function of comparison expresses itself in the various budgets as follows:

1. *The Sales Budget:*

- (a) Comparison of actual with estimated sales.
- (b) Determination of causes of variation.

- (c) Devising plans to counteract unfavorable tendencies.
 - (d) Carrying out the plans thru proper managerial co-operation with the sales department.
2. *The Receivables (or Receipts) Budget:*
- (a) Actual receipts compared to estimated receipts.
 - (b) Determining causes for any decreases in collections.
 - (c) Devising means to assure the collections as planned.
 - (d) Devising plans against a continuance of any unfavorable collections.
3. *The Selling Expense Budget:*
- (a) Actual expenses compared to estimates in all branches of selling expenses, such as salesmen's traveling expenses, advertising, etc.
 - (b) Determining causes for variations from estimates.
 - (c) Devising plans to eliminate unfavorable factors in selling expense.
 - (d) Carrying out the plans.
4. *The Manufacturing Budget:*
- (a) The actual production of salable goods as compared to the estimates.
 - (b) The determination of causes for variations.
 - (c) Providing plans for the elimination of weaknesses responsible for an unfavorable variation.
 - (d) Devising means to carry out the original planning.
5. *The Purchasing Budget:*
- (a) Actual purchases compared to scheduled purchases.
 - (b) The fixing of causes influencing changes in buying.
 - (c) Planning against improper buying as revealed by budget variations.
 - (d) Devising means to carry on with the budget or with modified purchasing, as dictated by possible changes in product or merchandise demand.
6. *The Inventory Budget:*
- (a) Actual inventories compared to planned inventories.
 - (b) The determination of changes in inventories from budgeted amounts.
 - (c) Planning against unbalanced inventories as revealed by changes therein.
 - (d) Carrying out the plans.

7. *The Administrative Budget:*

- (a) Actual expenses compared with budget.
- (b) Reasons for variations.
- (c) How to eliminate upward tendencies in administrative costs.
- (d) Planning to go ahead according to the budget.

8. *The Financial Budget:*

- (a) Actual financial condition as compared to budgeted status.
- (b) Reasons for variations (in receipts and disbursements).
- (c) The relation of the financial budget to the general budget, and thru the general budget to the departmental budgets.
 - (1) Planning against any unfavorable changes in the correlation of departmental budgets to the general and financial budgets.
 - (2) Devising plans to carry on with the financial budget after making all necessary detailed adjustments.

The Advantages of Budgetary Control. Analysis of business is largely confined to what has happened in the past; statistical and accounting facts are, in most cases "post mortems." Budgeting, however, is an analytical anticipation of what will and should happen in the future; it serves as a guide for future business acts and policies; it works out a business plan in advance, and affords the opportunity of saying where money shall be spent before it is spent, or of urging income realization along definite lines in conformity with well-thought-out methods.

Budgets permit an executive to look far ahead and to plan effectively for handling future problems before they arise, with the result that all the policies are readily adjusted in a co-ordinated and co-operative manner.

Budgets force an executive to think out a plan, and they impel him to draw his organization into close harmony with his policies; in other words, in order to carry out his plans, an executive must see to it that other

executives in his organization are familiar with all his plans, thus bringing about intelligent co-operation. In securing this co-operation, the budget, as administered by general management, naturally brings about a definite localization of functions and responsibilities.

Setting goals for nearly every one in an organization and having these goals accepted provide a very natural stimulus to good performance.

Then, if the goal also specifies the road by which it may be reached, errors in business practice are largely avoided.

Meeting Uncertain Factors in Budgetary Planning. Budgetary control, when capably administered, will be advantageous in any business. Careful study of past performances and of trends of change, coupled with analyses of present business conditions, based upon government statistics and general business forecasts, gives an executive a sound basis for future estimates. Even uncertain elements over which the average business man has little or no control, such as the weather, earthquakes, pests, strikes, style changes, and legislation—these should not upset the effectiveness of budgetary control; it should be remembered that some of these factors are not controllable by anyone and that they are likely to affect everyone.

There always have been and always will be uncertainties in business, but their existence gives no ground for opposing budgetary planning of business activities as far as the reasonable certainties are concerned. It is better to plan than to drift. If we permitted uncertainties to regulate our lives, we would never plan at all, and a business policy must nearly always give consideration to some uncertainties.

That budgets are a practical asset in business management is demonstrated by the fact that when budgetary control has been installed, it has in most cases been extended. Many business concerns now look upon bud-

getting as a necessity. Altho now practiced more extensively in the larger business concerns, budgeting offers proportionately as many advantages to the smaller business—when it is fully and properly established.

Limitations of Budgetary Control. Yet, a budget is, of course, not a “cure all.” It does not remove from executive control the need for making adjustments in business policies; and budgets work effectively only to the degree that they are faithfully adhered to, and to the extent that they secure the right kind of executive co-operation from both general and departmental management.

Budgets and budgetary control are limited by the limits which management itself places upon them.

To succeed, therefore, a plan of budgetary control must have the whole-hearted support of the chief executive, and of his responsible subordinates.

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In Executive Manuals 76 and 77, we shall take up the problem of gathering, analyzing, summarizing, and presenting statistical facts that underlie sound judgment and correct decisions that are vital to the control and progress of a business. Then, in Executive Manual 78, the problem of control thru executive reports will be analyzed.

CHECK-UP ON PRINCIPLES

Use the following check-up to get the principles of this manual firmly fixed in mind. This will help you to handle the problem which follows. This check-up is entirely for your own personal use, so you need not send it in to the University.

	Check	
	Yes	No
1. A company runs a line of steam packets down the Mississippi from St. Louis to Memphis, carrying both passengers and freight. Its ports of call and schedules are based on the requirements of public demand, and are to be the same as for some years past. Under these circumstances is a planning survey desirable? Do you recognize any operational factors for which plans can be made? Can sales be planned and scheduled? Does a financial budget seem desirable?		
2. A banker was counseling with a merchant whose business methods were rather slipshod, and urging him to adopt a budget plan of control. The banker stated that every business should be on a budget basis. "Do you prepare a budget showing in advance what kinds and amounts of loans you are going to make?" asked the merchant. The banker admitted that he did not. "Then what right have you to talk to me about budgets?" replied the merchant. Was this implied criticism justified?		
3. A department head in a house furnishing store is arguing for a complete use-departmentalization plan for this store. He wants one floor to be devoted to bedroom furnishings and to display there everything for the bedroom, including floor coverings, curtains, electric fixtures, wall paper, etc. Another floor would have everything for the dining room, again including appropriate floor coverings, etc. Other sections would be similarly stocked for other rooms. Does this degree of departmentalization appear practical to you?		

	Check	
	Yes	No
4. Another department head suggests that the stock should be divided so as to display all low-priced furniture and furnishings in one section, a somewhat higher grade in another, etc. He argues that people know about what they can pay and that this is a more sound basis for departmentalization than is a strict use-departmentalization. Do you agree with him?		
5. The permanent capital structure of the Griswold Woolen Manufacturing Company consists of \$650,000 of long-term bonds, \$400,000 of preferred stock, and \$500,000 of common stock. The company's surplus as shown by its latest balance sheet is, in round numbers, \$450,000. The management in setting its objectives for the coming year, plans on an anticipated profit of 15 per cent. Does this mean that it should figure on a profit in dollars of \$300,000?		
6. An advertising agency with an invested capital of \$40,000 does an average annual business of \$300,000. In making its profit calculations for an ensuing period, should it use its invested capital as a base?		
Its anticipated revenue for the period?		
7. In planning the production program for a factory, can management set a predetermined unit cost of overhead per operation, per machine-hour, or per man-hour?		
8. The Burrus Department Store is planning its anticipated income and expenses by departments for the second quarter of the year. Will the net profit which the notions department is planning to make on its estimated volume of sales affect the number of sales persons allotted to it?		
9. Should a financial budget for the year 1926 include items of accumulating expenses which will have to be met by cash outlays in 1927 and 1928?		
10. Should a budget be so broad as to include all the managerial policies of a business?		
11. Is a company following sound procedure if it permits discrepancies between its budget and actual accomplishments to influence changes in managerial policies?		

Executive Problem 75

USING THE BUDGET TO CONTROL COSTS

An Application of Budgetary Control Methods

UNDER THE LASALLE PROBLEM METHOD



A BUDGET is an expensive luxury unless it helps to make profits larger. It can do just that, but only when methods have been worked out which constantly show how closely budget and practice are agreeing—and even then only when these methods are followed and the results used in controlling the business.



Prepared by the Research and Consultation Staff of LaSalle Extension University from an interesting problem which it has carefully investigated and analyzed.

Executive Problem 75

USING THE BUDGET TO CONTROL COSTS

The Stewart-Oldfield Marketing Company makes and sells packaged food products. Its management is intelligent and progressive. For many years it has budgeted all the manufacturing expenses and has controlled these expenses by means of a very effective cost-accounting system. It has also budgeted the advertising, selling, and administrative expenses, making appropriations each year within which the expenses are kept.

The management is not satisfied with the extent of control that the present system is giving it, for these marketing expenses often run in excess of the budget. This is usually due to the fact that sales prove greater than have been anticipated—a very healthy condition, of course. They are striving now to work out a plan by which the marketing budget-and-cost system will reflect monthly the profits or losses on each of the three products which they are marketing. They want also to determine the relative profits and losses in each of the five marketing districts into which the domestic territory which they are now covering has been divided.

The table which you will find on the next page gives you the essential facts regarding this company's products and the appropriations that have been made for marketing them. Please understand, however, that the appropriations are not absolutely fixed. If sales prove larger than expected, the selling appropriation can be increased accordingly.

The three products are sold exclusively to jobbers and almost exclusively in carload lots, tho, of course, the three products are combined in making up carloads. Freight on carload lots is paid by the Stewart-Oldfield Marketing Company.

Name of Product	Pack-ages per Case	Gross Weight per Case	Whole-sale Prices per Case	Expected Volume of Sales (Cases)	Expected Volume of Sales (Dollars)	Advertising Appropriation			Appropriation for Selling and Administration			
						Over-head	For Space	For Sampling	General Office	Freight	Cash Dis-counts	Direct Selling
Eatsom..	48	46 lbs.	\$3.10	150,000	\$465,000	\$ 5,000	\$20,000	\$10,000	\$20,000	\$18,000	\$ 8,400	\$ 50,000
Bisom...	24	17 lbs.	1.85	180,000	333,000	3,000	20,000	8,000	16,000	8,000	6,000	40,000
Trisom..	36	23 lbs.	2.15	75,000	161,250	6,300	25,000	17,500	10,000	4,500	2,900	30,000
					\$959,250	\$14,300	\$65,000	\$35,500	\$46,000	\$30,500	\$17,300	\$120,000

The first two products listed have been on the market for some years—are well established. Trisom is a comparatively new product, however. This explains why the advertising appropriation for it is proportionately much larger than for the two other products.

As has been suggested above, the line is sold to jobbers by salesmen who work out of divisional sales offices. These divisional offices have no responsibility whatever for the general “space” advertising, but are charged with responsibility for handling the “sampling” crews who distribute sample packages from house to house. The sampling is done wherever it seems necessary in order to maintain the expected sales, and also to introduce new products.

Our problem is to devise a plan by which the company can tell from month to month what it is costing to market each of the three products, and also whether the branch offices are selling with the expected efficiency.

